NATIONAL GUARD AND RESERVISTS DEBT RELIEF ACT OF 2008

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

H.R. 4044

APRIL 1, 2008

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MATERIAL SUBMITTED FOR THE HEARING RECORD

NATIONAL GUARD AND RESERVISTS DEBT RELIEF ACT OF 2008

TUESDAY, APRIL 1, 2008

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:08 p.m., in rom 2141, Rayburn House Office Building, the Honorable Linda T. Sánchez (Chairwoman of the Subcommittee) presiding.

Present: Representatives Conyers, Sánchez, Delahunt, Watt, Keller, Feeney, and Franks.

Staff present: Susan Jensen-Lachmann, Majority Counsel; Daniel Flores, Minority Counsel; and Adam Russell, Majority Professional Staff Member.

Ms. SÁNCHEZ. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, will now come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing at any time.

I will now recognize myself for a short statement.

Since September 11, 2001, nearly half a million members of the National Guard and Reserve have been called to serve in Iraq and Afghanistan. As you might imagine, these lengthy and often unanticipated deployments not only disrupt the lives of these service members and their families, but can also lead to financial hardship. It is estimated, for example, that up to 26 percent of National Guard members who are deployed experience money problems as a direct result of their deployment.

You may also recall the very poignant testimony that we received at our hearing last May from a Chapter 13 debtor about her financial circumstances. She explained how after her husband, a member of the Army Reserve, was called to active duty and deployed to Iraq, the family income decreased by more than $1,000 per month, which, among other reasons, caused her and her husband to seek bankruptcy relief.

One would think that our bankruptcy law would honor the special contributions of these brave men and women who make so many sacrifices to protect our Nation. Sadly, it does not.

Exactly 3 years ago this very month, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act which contains some of the harshest changes in consumer

bankruptcy law in more than 25 years. One of the more draconian changes is the so-called means test, which requires debtors to prove their inability to repay their debts through a complex bureaucratic maze at the risk of having their cases dismissed for being an abuse of the system.

The means test is particularly unfair to National Guard and Reserve members both as a matter of principle and practice. Here is just one example: Service members, while serving in Iraq or Afghanistan, typically receive higher compensation in the form of combat pay, while they incur fewer living expenses. When they return to the United States, however, they receive less pay, and their expenses increase.

The means test, nevertheless, requires a debtor to calculate his or her income based on the average monthly income that he or she received during the 6-month period preceding the filing date of the bankruptcy case rather than the debtor's current income. As a result of the means test, a service member could appear to have higher net income and, therefore, be at risk of having his or her case dismissed for abuse.

To overcome this presumption, a service member must then demonstrate special circumstances which can oftentimes be a burden to undertake. This is not the way our consumer bankruptcy laws should work. Our service members deserve better.

Today, we are examining a proposed legislative remedy for this issue. H.R. 4044 would amend the Bankruptcy Code and create a narrow exception for the means test for a National Guard or Reserve member if he or she is on active duty or performs a homeland defense activity after September 11, 2001, for at least 60 days and for the first 6 months after completion of such service.

[The bill, H.R. 4044, follows:]

I

110TH CONGRESS
1ST SESSION

H. R. 4044

To amend the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to exempt from the means test in bankruptcy cases, for a limited period, qualifying reserve-component members who, after September 11, 2001, are called to active duty or to perform a homeland defense activity for not less than 60 days.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 1, 2007

Ms. SCHAKOWSKY (for herself, Mr. ROHRABACHER, Mr. ABERCROMBIE, Mr. BLUMENAUER, Mr. BUTTERFIELD, Mr. ANDREWS, Mr. BRADY of Pennsylvania, Mr. COSTELLO, Mr. DUNCAN, Mr. EHLERS, Mr. FARR, Mr. FATTAH, Ms. FOXX, Mr. GILCHREST, Mr. GORDON of Tennessee, Mr. HARE, Ms. HARMAN, Mr. HASTINGS of Florida, Mr. HONDA, Ms. HOOLEY, Ms. JACKSON-LEE of Texas, Mr. JEFFERSON, Mr. JONES of North Carolina, Mr. KUCINICH, Mr. MCGOVERN, Mr. MICHAUD, Mr. RUSH, Ms. SHEA-PORTER, and Mr. TIERNEY) introduced the following bill; which was referred to the Committee on the Judiciary

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A BILL

To amend the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to exempt from the means test in bankruptcy cases, for a limited period, qualifying reserve-component members who, after September 11, 2001, are called to active duty or to perform a homeland defense activity for not less than 60 days.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT.

Section 101(a)(2)(C) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Public Law 109–8) is amended by adding at the end of paragraph (2) of section 707(b) of title 11 of the United States Code, as added by such Act, the following:

"(E) Subparagraphs (A) through (C) shall not apply, and the court may not dismiss or convert a case filed under this chapter based on any form of means testing—

"(i)(I) while the debtor is on, and during the 180-day period beginning immediately after the debtor is released from, a period of active duty (as defined in section 101(d)(1) of title 10) of not less than 60 days; or

"(II) while the debtor is performing, and during the 180-day period beginning immediately after the debtor is no longer performing, a homeland defense activity (as defined in section 901(1) of title 32) performed for a period of not less than 60 days; and

"(ii) if after September 11, 2001, the debtor while a member of a reserve component of the Armed Forces or a member of the National Guard, was called to such active duty or performed such homeland defense activity.".

SEC. 2. EFFECTIVE DATE; APPLICATION OF AMENDMENT.

(a) EFFECTIVE DATE.—Except as provided in subsection (b), this Act and the amendment made by this Act shall take effect on April 20, 2005.

(b) APPLICATION OF AMENDMENT.—The amendment made by this Act shall apply only with respect to cases commenced under title 11 of the United States Code after April 20, 2005.

○

Ms. SÁNCHEZ. Accordingly, I very much look forward to hearing from our witnesses. In particular, I commend my colleagues, Representative Schakowsky and Representative Rohrabacher, for their leadership on this issue.

At this time, I would now like to recognize my colleague, Mr. Franks, for any opening remarks that he may have.

Mr. FRANKS. Well, thank you, Madam Chair.

And I want to welcome our witnesses. I especially would like to extend a warm welcome to our colleagues, Mr. Rohrabacher and Ms. Schakowsky.

As the Committee is all too aware, the regular Ranking Member, Mr. Cannon, is not here at this moment—he may be here a little bit later—he could not be, and so I am going to do my best to try to reflect his perspective here, if I can.

Madam Chair, the legislation that we are considering here today reflects what I believe is a bipartisan effort to do something which I think we all sympathize with. It is an effort to support our troops. Now the legislation seeks to help our Reservists and National Guardsmen affected by our wars in Iraq and Afghanistan.

Reservists and Guardsmen pay a particular and very practical sacrifice when they are called to duty. Unlike most of our troops, they have to come off the civilian pay scale and adopt—or I should say adapt—to the lower military scale in most cases. There are reports that some of these patriotic men and women, especially those whose savings may be low when they report to duty in the first place, can be pushed over the financial brink when they take that pay cut. Strangely, they may have to consider bankruptcy in the wake of reporting for service.

I think that is something we could all collectively say that we are very concerned with. H.R. 4044 responds by seeking to lift the means test in Chapter 7 bankruptcy, making it easier for hard-pressed Reservists and Guardsmen to wipe their debt slates clean and start over again. I applaud that concern, and I applaud the concern that has actually produced the proposal.

But I want to sound a few notes of caution about the issues that I think we have to explore today and that may give us reason to ask whether we ought to propose some different responses. For example, I question whether or not we should make bankruptcy easier for these noble men and women instead of making it easier for them to stay out of bankruptcy in the first place.

And I also want to highlight that service men who are teetering on the brink of bankruptcy may not lose just their personal assets. They may lose their security clearances according to the Department of Defense press release, and if we help them go into bankruptcy instead of helping them stay out of it, we may create an actual national security problem, increasing numbers of Reservists and Guardsmen serving in the war on terror without the security clearances they need to fight that war.

When we consider relaxing the means test for these service men, we should also ask ourselves if, in so doing, we might also undermine other provisions of the laws affecting them, such as the Soldiers and Sailors Relief Act, which exists to protect service men.

I raise these questions not necessarily in opposition to the bill, but to perform the vital role that only this Subcommittee can ful-

fill, and that is to make sure that before enacting legislation affecting the Bankruptcy Code that we are sure what we are doing is necessary, number one; number two, that it will not unduly undermine other important interests; and, finally, that it will work because bankruptcy, as we all know, Madam Chair, should always be a last resort, and I think that is true in the minds of the service men themselves as well.

And finally, I raise a note of caution because the means test is at the heart of the consumer bankruptcy reforms we enacted in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. I think we should be especially vigilant of attempts to undo that. I think it is imperative that we ask today the kinds of questions I am proposing. Our country and our service men deserve no less than the most honest and diligent effort that we can deliver in this proposal or any other to make their lives better and to help them.

Madam Chair, with that, I thank the witnesses, look forward to your testimony, and yield back my time.

Ms. SÁNCHEZ. Thank you, Mr. Franks, and I appreciate you filling in for Mr. Cannon today.

Without objection, other Members' opening statements will be included in the record.

[The prepared statement of Mr. Cannon follows:]

PREPARED STATEMENT OF THE HONORABLE CHRIS CANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH, AND RANKING MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Thank you Madam Chair and welcome to our witnesses. I'd like to extend a particularly welcome to our colleagues, Mr. Rohrabacher and Ms. Schakowsky.

The legislation we are considering today reflects a bipartisan effort to do something with which I think we all sympathize. That is, to support our troops.

The legislation seeks to help our reservists and National Guardsmen affected by our wars in Iraq and Afghanistan. Reservists and guardsmen pay a particular and very practical sacrifice when they are called to duty. Unlike most of our troops, they have to come off of the civilian pay scale, and adapt to the often lower military pay scale.

There are reports that some of these patriotic men and women—particularly those whose savings may have been low when they report for duty—can be pushed over the financial brink when they take that pay cut. Strangely, they may have to consider bankruptcy in the wake of reporting for service.

I suspect we all agree that is something we should be concerned with.

H.R. 4044 responds by seeking to lift the means test in Chapter 7 bankruptcy, making it easier for hard-pressed reservists and guardsmen to wipe their debt slates clean and start over again.

I applaud the concern that produced this proposal. But I want to sound several notes of caution about issues that I think we must explore today, and that may give us reason to ask whether we ought to propose a different response.

For example, I question whether we should be making bankruptcy easier for these fine men and women, instead of making it easier for them to stay out of bankruptcy.

I also want to highlight that servicemen who are teetering on the brink of bankruptcy may not lose just their personal assets. They may lose their security clearances according to Department of Defense precedents. If we help them get into bankruptcy, instead of help them stay out of it, we may create a real national security problem—increasing numbers of reservists and guardsmen serving in the War on Terror without the security clearances they need to fight that war.

When we consider relaxing the means test for these servicemen, we also should ask ourselves if, in doing that, we might also undermine other provisions of the law affecting them, such as the Soldiers' and Sailors' Relief Act, which exist to protect servicemen.

I raise these issues, not necessarily in opposition to the bill, but to perform the vital role that only this Subcommittee can fulfill. That is to make sure that before

enacting legislation affecting the Bankruptcy Code, we are sure that what we are doing is necessary, will not unduly undermine other important interests, and will work.

Because bankruptcy, as we all know, should always be a last resort.

Finally, I raise a note of caution because the means test is at the heart of the consumer bankruptcy reforms we enacted in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

I think we should be especially vigilant of attempts to undo it. I think it is imperative that we ask today the kinds of questions I am posing. Our country and our servicemen deserve no less than the frankest, most fair assessment we can deliver of this proposal to help them.

I yield back the remainder of my time.

Ms. SÁNCHEZ. I am now pleased to introduce the witnesses for our first panel for today's hearing.

Our first witness is Congresswoman Jan Schakowsky. She represents the Ninth Congressional District of Illinois. Ms. Schakowsky was first sworn in as a Member of the House of Representatives in 1998 and, since then, has continued her fight for economic and social justice, improved quality of life for all, and a national investment in health care, public education, and housing needs.

Ms. Schakowsky serves on the Steering and Policy Committee, the House Select Committee on Intelligence, and the House Energy and Commerce Committee as Vice Chair of the Subcommittee on Commerce, Trade, and Consumer Protection. She is also a Member of both the Subcommittee on Health and the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee.

Ms. Schakowsky is the sponsor of H.R. 4044.

Our second witness is Congressman Dana Rohrabacher who represents the 46th District of California. Elected to Congress in 1988, Mr. Rohrabacher champions human rights and democracy. He serves as the Ranking Member of the Investigations and Oversight Subcommittee of the House Committee on International Relations and as a Member of the House Committee on Science.

Mr. Rohrabacher is an original co-sponsor of H.R. 4044.

I want to thank you both for your willingness to participate in today's hearing. Without objection, your written statements will be placed into the record, and we would ask that you limit your oral testimony to 5 minutes.

You will note the lighting system. I am sure you are both familiar with it. When your time begins, you will get the green light. Four minutes in, you will receive a yellow light, letting you know that you have a minute to finish your testimony, and we will hit the red light when the time expires. We, of course, will allow you to finish any concluding thoughts before moving on to our next witness.

After each witness has presented his or her testimony, Subcommittee Members will be permitted to ask questions subject to the 5-minute limit.

With that, I would invite Ms. Schakowsky to please proceed with her testimony.

TESTIMONY OF THE HONORABLE JANICE SCHAKOWSKY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Ms. SCHAKOWSKY. Thank you very much, Chairwoman Sánchez, Mr. Franks, and the rest of the Subcommittee. I appreciate so much your holding the hearing today for the members of the National Guard and Reserve who face bankruptcy when they return from service.

Let me depart from my written statement and reply just briefly to Mr. Franks. You know, when Congress first passed in 2005 the new Bankruptcy Act, Congress did have the wisdom to exempt disabled veterans from the means test, and so we see this as a very narrow addition to that at the Guard and Reserve as well.

And I could not agree with you more that we should do all that we can to prevent the situation from these heroes having to face bankruptcy in the first place, but having said that, we know that some will, and so this is to address those, and we do not know how many, although we know, as the Chairwoman said, since 9/11, more than 460,000 Reservists and Guardsmen have been called to active duty in Iraq and Afghanistan, and a quarter of those more than once.

These men and women have left their jobs and families to answer the call often with little or no notice. Service members who own and operate small businesses put their businesses on hold, sometimes sacrificing them altogether, while they serve their country. Many service members face unexpected extended tours of 15 months or longer, leaving them with almost no way to prepare financially.

You mentioned, Mr. Franks, those who lose money when they go on active duty, but it also works the other way, too. The means test for veterans who file for bankruptcy has a particularly adverse income on some of them because, again, as the Chairwoman mentioned, combat pay of soldiers in Iraq or Afghanistan may be higher than their salaries at home, and they have fewer expenses when they are overseas so that when they return home, these individuals face lower incomes and higher expenses, and because the means test factors in a person's income and expenses for the 6 months preceding bankruptcy filing, sometimes a veteran's income is artificially inflated, and their expenses seem unduly low, and as a result, they risk failing the means test and facing Chapter 11 or Chapter 13.

So our bill would simply allow the National Guard and Reservists to file for bankruptcy without the burden of the means test. We have 46 cosponsors, including 14 Republicans. It is a bipartisan piece of legislation, and it would only apply to the heroes who have served in the armed forces for more than 60 days since September 11, 2001, and would exempt them from the test for up to 180 days after they return home.

I would love to be able to tell you how widespread the problem is. The Veterans Administration reports that veterans have difficulties finding a job in the first 2 years after they return home, and that they are more likely to earn lower wages.

Today's *Washington Post* ran a front-page article in their business section on how bleak the market is—18 percent of veterans re-

cently back from tours of duty are unemployed, and of those who have been able to find work, 25 percent earn less than $22,000 a year. There are also currently 1,500 veterans of the wars in Iraq and Afghanistan who are homeless, and thousands of veterans return from the war with physical and mental injuries which make returning to work difficult or impossible.

The Illinois Department of Veterans Affairs assists many veterans who face financial hardship, and I would like to ask unanimous consent, Madam Chairwoman, to insert statements into the record from caseworkers who, too often, assist veterans facing financial collapse, if I could put those into the record?

Ms. SÁNCHEZ. Without objection, so ordered.

[The information referred to follows:]

MATERIAL SUBMITTED BY THE HONORABLE JANICE SCHAKOWSKY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Statement of Deanna Mackey , MSEd, LCPC
Program Director, Homeless and Disabled Program
Illinois Department of Veterans' Affairs

Judiciary Subcommittee on Commercial and Administrative Law Hearing on H.R. 4044
April 1, 2008

I have found that the financial challenges Veterans have are unique to that of the average individual. In my opinion the effect can be several fold. If in fact the Veteran in question has good credit prior to reporting for duty deployment, I almost always hear that something goes wrong during their absence from home. Whether it is person with the power of attorney failing to handle the finances in the same matter or if there is a lack of adequate funds is questionable. Then again I hear stories of fraud against veterans during deployment.

Another problem is related to all the ills that a veteran must deal with upon return, the same ills that challenge their existence such as mental health, physical health, relationship problems as well as substance abuse issues. These challenges are the same ones that lead to destruction of families, homelessness and hopelessness. It is also found that many times a veteran in route to financial ruin fails to act to intervene in the process with a formal declaration of bankruptcy. Soldiers by their makeup are seen to be prideful and strong, reaching out for help in any area is difficult.

Any legislation to assist in this arena would be most beneficial.

Statement of Mr. Harry Sawyer
Manager of Field Services
Illinois Department of Veterans' Affairs

Judiciary Subcommittee on Commercial and Administrative Law Hearing on H.R. 4044
April 1, 2008

In the State of Illinois, I supervise over 70 Veteran Service Officers who assist Veterans with obtaining their federal and state benefits. The Veteran Service Officers see a wide range of clients and it is abundantly clear that our Service Members are experiencing significant strains, especially with their finances and home life.

This is especially the case with Members of the National Guard and Reserves who are called to active duty and are unprepared financially to leave a for an entire year. In many cases their incomes may be substantially reduced in theatre compared to their civilian pay and they are often unable to make their regular mortgage payments, insurance payments, car notes, electric bills, heating, water and other financial obligations.

Our Service members tend to be young, getting married early and have young children at home when deployed. The spouse at home is left with all the responsibility of getting the kids to school, childcare, meal preparation, grocery shopping, and in many cases has the financial responsibilities of the entire household for the first time.

The spouse at home has to deal with all of the finances, is often unprepared and does not have the experience of dealing with these duties in additional to the full responsibility of making the family function on a day to day basis alone. The lack of familiarity of the financial obligations and money management skills may lead to bouncing checks and increased credit card debt. These are single parent households under tremendous strain.

These families are living paycheck to paycheck and in many cases one unforeseen incident can break the bank. It is simply too difficult to project what the unforeseen circumstances that may arise over the coarse of a year and prepare accordingly. So not only is the Service Member under stress, the family life for those at home is extremely challenging. After all is said and done, families have to cut back on groceries and clothing.

When they return to civilian life, these service members are usually so far into debt that it takes years for them to recover and they are often facing a redeployment. They are often forced to seek emergency aid from organizations such as Salute, USA Cares and Centennials of Freedom to keep the lights on.

In addition, if they are redeployed, it can lead to increased difficulty at home. This disruption of life causes marital challenges leading to divorce, strain on families, children suffering the loss of a parent and these are things they can't get back. This does not bode well for the American Service Member.

With a sustained war, Members of the National Guard and Reserves who are redeploying two or three times are no longer receiving 15 day R&R leave and 4 day R&R pass. They face significant financial stress of leaving a job for a year, with 10 months in theatre without the appropriate break during the year.

All of these circumstances make it extremely difficult for our Service Members to stay afloat and they are in need of broader ranging assistance now.

Ms. SCHAKOWSKY. Our legislation would help returning service men like Jeremy W., a hero from my State, who was deployed from March 2006 to 2007, June of 2007. He is a member of the National Guard and, like many others, asked not to be identified because of the stigma surrounding financial problems.

After he returned, he did not want to be away from his family. He decided not to return to his previous job as a truck driver, instead opting to take a lower-paid job. He now works 6 days a week to pay his bills and is teetering on the brink of losing his house.

The men and women who will risk their lives to protect us deserve protection in return. These selfless individuals should not face harsh bankruptcy procedures if they are in financial distress when they return home, even after we have tried to help them, and so when changes are made to the bankruptcy laws, they work for the disabled veterans, we hope that we will do the same for the Reservists and National Guard.

Thank you.

[The prepared statement of Ms. Schakowsky follows:]

PREPARED STATEMENT OF THE HONORABLE JANICE D. SCHAKOWSKY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Statement of Congresswoman Jan Schakowsky and
Congressman Dana Rohrabacher
Subcommittee on Commercial and Administrative Law Hearing on H.R. 4044
April 1, 2008

Chairwoman Sanchez, Ranking Member Cannon, thank you for holding today's hearing on members of the National Guard and Reserve who face bankruptcy when they return from service.

Since 9/11, more than 460,000 reservists and guards men and women have been called to active duty in Iraq and Afghanistan. One quarter of those courageous men and women have been deployed more than once. Members of the National Guard and Reserves make up 13 percent of total U.S. forces in Iraq and an astounding 21 percent of U.S. forces in Afghanistan. These men and women have left their jobs and families to courageously enter the theater of battle, often with little or no notice and without adequate time to prepare for the financial challenges that their deployments will present.

According to the National Guard, four out of 10 members of the Reserves and National Guard lose money when they leave their civilian jobs for active duty. This is especially true for servicemembers who own and operate small businesses. These entrepreneurs put their businesses on hold, sometimes sacrificing them altogether, while they serve their country. Additionally, many members of the Guard and Reserves leave for the war thinking they will only be deployed for 6 to 12 months, and end up staying for fifteen months. There is almost no way that they can anticipate or and prepare for that extension of their service financially.

Because the forms used in bankruptcy petitions do not ask for veteran status there is currently no data available on the numbers of veterans who have filed for bankruptcy. Unfortunately, neither the Department of Defense nor the Department of Veterans Affairs (VA) keep estimates of the numbers of veterans who file for bankruptcy. However, we know that even before 9/11 many members of the military had to file for bankruptcy. A 2004 Government Accountability Office study reported that 16,000 active duty military personnel filed for bankruptcy in 1999.

While there are no figures available for the number of veterans filing for bankruptcy, an array of economic indicators point to increasing hardship for veterans. A 2007 report commissioned by the VA found that veterans have difficulties in finding their first civilian job within the first two years after they return home. As compared to their peers with the same educational attainment and demographic characteristics, these veterans are more likely to earn lower wages, especially among the college-educated. Eighteen percent of recently separated servicemembers are currently unemployed, and of those employed since separation twenty five percent earn less than $21,840 a year.

Our legislation would help returning servicemembers like Jeremy W., a member of the National Guard who, like so many others, does not want to be identified because of the stigma surrounding financial distress. Jeremy was deployed to active duty in Iraq from

March 2006 to June 2007. After he returned, he didn't want to be away from his wife, 4 year-old daughter and 7 year-old son, so instead of returning to his previous job as a truck driver, he took a lower-paying job. Jeremy now works 6 days a week to pay the bills and is teetering on the brink of losing his house.

We want to help people like Mrs. Vicky Wessel. When she appeared on "60 Minutes" in 2004, she expressed the concerns shared by many families of reservists whose husbands or wives have been called to active duty experience. When asked why she was having financial difficulty, she said, "It is because a staff sergeant's pay is a 60 percent cut in pay from my husband's regular job."

There are thousands of families like the Wessels, who struggle financially while a family member is deployed and after they return from their tours. Many veterans who cannot return to work or return to lower paying jobs even end up homeless. The VA estimates that on any given night in 2007, 154,000 veterans were homeless, and that there are 1,500 homeless veterans of the wars in Iraq and Afghanistan. It is shameful that after serving our country, many veterans face such dire financial circumstances that they lose their homes and many end up living on the streets.

Record numbers of veterans are also returning home severely injured. A staggering 31,000 service members have been injured in combat in the wars in Afghanistan and Iraq. Compared with previous wars that the nation has fought a larger proportion of soldiers are surviving their injuries because of the advancement in battle field medicine. In World War II, 30 percent of U.S. servicemembers injured in combat died. In Vietnam, the proportion dropped to 24 percent. In Operation Enduring Freedom in Afghanistan (OEF) and Operation Iraqi Freedom (OIF) about 10 percent of those injured have died.

The Veterans Administration reports that increasing numbers of severely wounded servicemembers are returning home, many requiring prosthetic limbs and extensive medical treatment. Since FY2002, the VA's Prosthetic and Sensory Aids Service has provided services and products to over 22,000 veterans of Iraq and Afghanistan. Many of these men and women will never be able to return to their previous employment and may face long periods of rehabilitative care to get back on their feet.

Thousands of veterans are also returning with traumatic brain injury (TBI) and post traumatic stress disorder (PTSD) which may make returning to work impossible. The VA began screening veterans for TBI in April 2007 with startling results. Of the 61,285 veterans that VA has screened for TBI to date, 11,804 (19 percent) screened positive for TBI symptoms.

In April 2005, the *Bankruptcy Abuse Prevention and Consumer Act* became law, changing the way individuals have to discharge their debts in bankruptcy. A provision in this legislation requires individual debtors who file for bankruptcy to submit to a means test which assesses their eligibility to file for bankruptcy protection. H.R. 4044 would provide safe harbor from this means test for members of the National Guard and Reserves who have returned from service and are facing bankruptcy.

The means test involves a lengthy and complicated process which can end with being denied the ability to file for bankruptcy protection. H.R. 4044 would simply allow National Guard and Reservists to file for Chapter 7 without the added paperwork burden and other obstacles that the means test presents. The bill would only apply to our citizen soldiers who have served in the armed forces for more that 60 days since September 11, 2001, and would only exempt them from the test for only up to 180 days after they return home. We would be happy to work with the committee to extend that time period if you feel that it is appropriate.

Veterans and their families who must file for bankruptcy face the means test, which does not accurately judge their ability to repay their debts. The means test has a particularly adverse impact on servicemembers who, while deployed in Iraq or Afghanistan, receive higher compensation in the form of combat pay and have fewer expenses. Upon leaving service those individuals face lower income and higher expenses, but because the means test factors in a person's income and expenses for the six-month period *preceding* the bankruptcy filing, a veteran's income is artificially inflated income and their expenses seem unduly low. As a result, these servicemembers risk having their chapter 7 case dismissed and being forced to file under the stricter chapter 13.

The men and women who have risked their lives to protect us deserve protection from us in return. They don't deserve to be penalized for their service through greater hardships. These are people who, through no fault of their own, may end up in bankruptcy. They risk their lives for us, give up promising careers and small businesses, and should not face harsh bankruptcy procedures if they are in financial distress when they return home. When the changes to bankruptcy law were made in 2005, Congress saw the importance of exempting disabled veterans whose debts were incurred while they were on active duty from means testing. Our bipartisan legislation would allow the same flexibility for those heroes returning from active service in the Guard and Reserves.

Ms. SÁNCHEZ. Thank you, Ms. Schakowsky. We appreciate your leadership on this issue and your taking the time to testify before the Subcommittee today.

At this time, I would invite Mr. Rohrabacher to please begin his testimony.

TESTIMONY OF THE HONORABLE DANA ROHRABACHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. ROHRABACHER. Thank you very much, Chairwoman Sánchez, Representative Franks, and other Members of the Subcommittee.

We thank you for holding this hearing on H.R. 4044, a bipartisan bill that I originally introduced in the 109th Congress with the co-sponsorship of Representative Schakowsky, and it was reintroduced by Representative Schakowsky this year and myself as a co-sponsor.

Let me note that this change was first proposed by Representative Schakowsky as a motion to recommit in the original bankruptcy reform bill. I was misinformed by the Republican leadership on the floor of the House at that time. I was told that this motion to recommit was redundant to changes that already existed in the law, and I was very upset when I found out that I had been misinformed and had voted the wrong way.

At that time, I pledged myself to work with Representative Schakowsky to correct that situation, and that is what this bill is all about, correcting what should have been a no-brainer to begin with, except that politics got in the way. This bill makes a very small and targeted change to the current bankruptcy law and places our National Guard and Reservists veterans under the bankruptcy law in place prior to 2005.

Let me note at this time that I am a strong supporter of the Bankruptcy Reform Act that passed. Unfortunately, this should have been in that bill.

As members of the National Guard and Reservists return from their tours of duty in Afghanistan and Iraq, they can face a new battle at home, which we have just heard. Quite often, these patriots will face financial hardship as they left better paying jobs to serve our country. For those members of the National Guard and the Reserves who deal with mounting bills during their time away and face bankruptcy upon their return, H.R. 4044 provides that these heroes will be treated under the prior system, which did not require them to repay all of their debts accumulated as a result of their service.

This bill has been written to provide a small and targeted change to the bankruptcy law for a select group of people who deserve it the most. It is important to note that this bill will not apply to the entirety of the armed forces, as we just heard. The fact is many of those in the regular armed forces do not have the same problem. It is just for the members of the National Guard and Reserves who have been called on to disrupt their lives at home and to serve lengthy tours overseas.

Prior to 9/11 and the Iraq war, these veterans could have been relatively assured that they would have a regular schedule; they would not face this disruption in their life for long periods of time.

That has changed since 9/11, and now, quite often, we throw the Reserves and National Guard into economic and personal chaos as we call them up to defend their country.

National Guard members and Reservists now have very little idea how long they must be away from home, and when they return, they may be called up again. So these veterans do not know exactly what their economic situation is going to be, and for this reason, they need to be treated in a special way. It is for this reason the National Guard and Reservists deserve this change.

These heroes have made tremendous sacrifices for the sake of this Nation, and this bill will simply ensure that these heroes will not face bankruptcy and face a negative outcome for the fact of their service to the country. So I wholeheartedly support this amendment, and I certainly commend my fellow Representative for the hard work that she has put into this from the very beginning, since the day that we passed the bankruptcy bill when the Republicans were in the majority, when this should have been in that bill in the first place, and some of us who wanted to vote for it were misinformed as to whether or not this was actually being taken care of.

So thank you very much, and I would ask my Republican and Democratic colleagues to support this reform.

[The prepared statement of Mr. Rohrabacher follows:]

PREPARED STATEMENT OF THE HONORABLE DANA ROHRABACHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Statement of Congressman Dana Rohrabacher
Member of Congress
Subcommittee on Commercial and Administrative Law Hearing on H.R. 4044
April 1, 2008

Thank you, Chairwoman Sanchéz and Ranking Member Cannon for holding this hearing on H.R. 4044, a bi-partisan bill that I originally introduced in the 109th Congress with the co-sponsorship of Representative Schakowski, and was re-introduced by Representative Schakowsky, and myself this year. This bill makes a small and targeted change to the current bankruptcy law, and places our National Guard and reservist veterans under the bankruptcy law in place prior to the 2005 changes.

As members of the National Guard and reservists return from their tours of duty in Afghanistan or Iraq, they can face a new battle at home. Quite often, these patriots will face financial hardship, as they left better paying jobs to serve our country. For those members of the National Guard and the Reserves who deal with mounting bills during their time away, and face bankruptcy upon their return, H.R. 4044 provides that these heroes will be treated under the prior system which did not require they repay all their debts accumulated as a result of their service.

This bill has been written to provide a small and targeted change to the bankruptcy law for a select group of people who deserve it the most. It is important to note that this bill will not apply to the entirety of the armed forces, just those members of the National Guard and Reserves who are called to disrupt their lives at home and serve for lengthy terms overseas.

Prior to 9/11 and the Iraq War, these veterans could be relatively assured that they would have a semi-regular schedule, and while they always knew, that they could be called up at any time, they could be relatively assured that they would have a semi-regular schedule, with the vast majority serving only a period of weeks at a time, rather than the months and years many are serving now.

National Guard members and Reservists now have very little idea how long they must be away from home, when they may return, and they don't know how long they have until they may be called up again. These veterans do not know how long they must leave their job, or how long they must operate on a reduced salary. It is for this reason that the National Guard and Reservists deserve this change. These heroes have made tremendous sacrifices for the sake of this nation. This bill simply ensures that these heroes will not face the bankruptcy payments these patriots could have avoided had they not served.

I thank the Committee and I urge your support for this bill.

Thank you.

Ms. SÁNCHEZ. Thank you.

I want to thank the first panel for their testimony. I know that Ms. Schakowsky has an Energy and Commerce Committee commitment, so if you need to be excused, you may leave at any time.

I personally do not have any questions for the witnesses. Does any——

Mr. WATT. Madam Chair?

Could I just encourage both of my colleagues to look at the title to this bill, which I think is very misleading? Actually, the means test is the only thing that was worth having in the bankruptcy reform bill. So when you say exempt people from the means test, that is not what you are doing, and I do not think that is what the language of the bill actually does.

It actually gives service people, regardless of their prior income, the benefit of having a means test. It does not exempt them from the means test because the means test itself is a positive thing. It is about the only thing that was positive in the bankruptcy reform bill when you get right down to it.

So I think your bill is misnamed, is the point I am making, and I hope you all will take a look at that.

Ms. SÁNCHEZ. Does the gentleman yield back his time?

Mr. ROHRABACHER. Thank you for that analysis. I appreciate that.

Ms. SÁNCHEZ. Any other Members have questions?

Mr. Franks is recognized for 5 minutes.

Mr. FRANKS. Well, thank you, Madam Chair.

I guess, Ms. Schakowsky, I will address it to you first, and then Mr. Rohrabacher can respond as well.

Is there a possibility that the service men would be exempted already and qualify for relief under the circumstance already because we put a special circumstances provision in the legislation, and is that provision not applied or not adequate to the task that you are trying to accomplish here?

Ms. SCHAKOWSKY. It is not adequate to the test, and, actually, that was the intention of this amendment, was to make sure that these individuals were covered, and that was the information that you were told, that they were covered, but they are not.

Mr. FRANKS. And just for clarity, I mean, this is really the only issue you are trying to address here, not down the road that there would be an additional expansion of this? This is the only thing?

Ms. SCHAKOWSKY. No. No. As Mr. Rohrabacher stated, this is a very narrow, targeted bill, something I had tried initially to have as part of the bankruptcy bill, just like the disabled veterans, and this is it.

Mr. FRANKS. Mr. Rohrabacher, is there anything you want to add to that?

Mr. ROHRABACHER. There should be no doubt at all after this bill what the intent is, and from the people who I have spoken to, there is doubt as to the way it is now.

Mr. FRANKS. Madam Chair, I just would applaud the attitudes and the motivations of both of the Members there. Obviously, they are trying to do something that they believe is important to the cause of helping our service men and women.

So, with that, I yield back.

Ms. SÁNCHEZ. The gentleman yields back the balance of his time.

Any other Members seek to be recognized?

Mr. DELAHUNT. Madam Chair?

Ms. SÁNCHEZ. Mr. Delahunt is recognized for 5 minutes.

Mr. DELAHUNT. I wonder if our colleagues would consider, rather than 6 months, a longer period of time. I think what we are discovering is when the men and women return from active duty, just the readjustment, if you will, to civilian life—in some cases, their ability to come back into the workplace is a difficult transition.

In 6 months, to us, while we sit here in Washington and have discussions about what is happening in Iraq, Afghanistan, and elsewhere in the world, the reality, I think, that these men and women face is something entirely different. And I wonder how quickly that readjustment back into civilian life, what all of that entails, might require more than 6 months.

I was just discussing with the former Ranking Member here, Mr. Watt, the possibility of a friendly amendment about a year or something along those lines. But I just put it out to——

Ms. SCHAKOWSKY. Let me just say that I would certainly see that amendment as a friendly amendment to the legislation.

Mr. ROHRABACHER. I would not rule it out. I would suggest that we need to, you know, make a decision of what that date is and move forward.

Ms. SÁNCHEZ. The gentleman yields back?

The gentleman yields back his time.

Any other Members?

Mr. Keller?

Mr. KELLER. Thank you, Madam Chairwoman.

I see Mr. Rohrabacher and Ms. Schakowsky co-sponsoring the bill. I am wondering if both of you have read it here. You seem such polar opposites philosophically, but you have come together on a good cause here.

Ms. SCHAKOWSKY. Actually, we are best friends.

Mr. KELLER. Well, good deal.

Do you agree with that characterization?

Mr. ROHRABACHER. Oh, yes, I do. And, in fact, I remember talking to a particular Republican leader on the floor and saying, "Why are we opposing this? This is a no-brainer."

Mr. KELLER. Yes.

Mr. ROHRABACHER. And then being assured, "Well, do not worry. This is all redundant, and that is just a political maneuver on their part," and the fact is I believe that it was a political maneuver on the part of that Republican leader, unfortunately.

Mr. KELLER. Well, I saw Rohrabacher scribbling on a piece of paper "Schakowsky BFF," and I wondered what that meant. Now I know. You are best friends forever.

Let me ask you this, Mr. Rohrabacher. I could tell you were impassioned. You are a little upset. You felt you were misinformed about the motion to recommit that Ms. Schakowsky offered by you being told by someone that it was redundant. I am guessing—because I was not there—that they probably suspected that Ms. Schakowsky's concerns were already covered by these special circumstances provisions.

I know that you feel that that provision is not adequate. Could you just elaborate on that?

Mr. ROHRABACHER. Well, I just, frankly, had my staff look this up and do an analysis for me, and they came to that conclusion that, no, they are not covered and they are not part of that category. Let me put it this way. When I got that report back, I was devastated.

Mr. KELLER. Right. What are you hearing—and this is to both of you—from your constituents about Reservists and Guardsmen being forced into bankruptcy by their call to active service?

Ms. Schakowsky, maybe we will start with you.

Ms. SCHAKOWSKY. Yes, we do hear about the financial problems of our service men and women. You know, we wanted to have veterans' service organizations to testify. We wanted to have that. But you know what? We identified some, and it is embarrassing. They felt embarrassed to come and talk about their personal financial problems.

But there is no doubt that they exist, and, as I said, if you look at the front page of *The Washington Post* business section today, it talks about just how tough it really is for our returning National Guard and Reservists.

Mr. KELLER. So the problem is, in your observation, more widespread than most of us know because of the embarrassment that a lot of these folks do not come out and say how this is impacting them because they are——

Ms. SCHAKOWSKY. Well, the other reason is because no records are actually being kept of that. So, while we know anecdotally and the veterans' service organizations know about it and our Department of Veterans Affairs knows about it, we actually do not have hard data to tell us that. So, you know, we do not know if it is 1,000 or 10,000. We know who these people are.

Ms. SÁNCHEZ. Will the gentleman yield?

Mr. KELLER. Sure.

Ms. SÁNCHEZ. In sort of setting up the two panels for today's hearing, we came to understand that when a debtor files for bankruptcy, there is no box that you check to identify yourself as a service member or not. So there is no particular way currently to keep those kinds of records, and I think, therefore, it is difficult for anybody to know how many people are affected.

But we will be hearing from witnesses on the second panel much testimony about the members that it actually does affect.

Mr. KELLER. Right. Thank you.

Mr. ROHRABACHER. Well, if I could answer your question——

Mr. KELLER. Yes.

Mr. ROHRABACHER [continuing]. As well——

Mr. KELLER. And I will ask you what you are hearing anecdotally or statistically, whatever you heard.

Mr. ROHRABACHER. Right. Los Alamitos Reserve Center is in my district. Or, actually, it is on the edge of my district. It used to be in my district before redistricting. And many of the troops in Southern California, Reserves and National Guard troops, that have been away serving our country either deploy from Los Alamitos, or they come back to Southern California to Los Alamitos.

I have made it my personal mission to go and see off every National Guard and Reserve unit that leaves from there that I can possibly do—it is part of my schedule if I am back there and not here in Washington—and to welcome them home as well, and so I have had a lot of interaction with Reserves and National Guard, and more than anything, you know, I have received the frustration of some of these people who are away from their families and while they are gone that their economic house is put in total disarray and they come back confused.

They are frightened. They are frightened they are going to lose their home. Their whole life is different than it was a year before only because they have gone off and served their country, and just over and over again, I was told about this fear that they have, and that is why, as I say, when this motion to recommit came up originally—and there should be no doubt whether or not these people are put in an exceptional category. They should not be.

And what is wrong with reaffirming if, indeed, they already are covered, which I do not believe they are? But if they are, if somebody says, "Well, it can be argued that they are," well, let's just reaffirm it. What is the problem? And as I say, that motion to recommit should have been accepted because if it was redundant, why not reaffirm it?

Just like today, there is no reason not to reaffirm it because these people need to know that we care about them, and they need to know when they are coming back and their total life is in chaos compared to 2 years before that they are not going to have a hammer come down on their head, and whether it is 6 months or a year, we can talk about that, but that came to me. That was the most spoken not complaint, but concern of these people who were leaving and coming back, and as I say, I must have done this 30 times over the last 5 years.

Mr. KELLER. Well, Madam Chairman——

Ms. SÁNCHEZ. The time of——

Mr. KELLER [continuing]. I know my time has expired, but if you would just indulge me for a few seconds, I just want to commend both of my colleagues for working on this very worthy task to protect the Reservists and Guardsmen and their families, and I appreciate your bipartisan spirit and will yield back the balance of my time.

Ms. SÁNCHEZ. Okay. The gentleman yields back.

Are there any other Members who wish to be recognized?

Mr. Feeney?

Mr. Feeney is recognized for 5 minutes.

Mr. FEENEY. I think I just have one question. Is there a time limit for a Reservist under your bill in terms of their ability to take advantage of the provisions of your bill, and what is it, a year or 5 years?

Ms. SCHAKOWSKY. Actually, it is only 180 days, which was the essence of what Mr. Delahunt was saying, that, in his view, it may be too short. You know, it was written rather modestly, but they would be exempt from the test only in our bill for 180 days, and so, you know, I actually would concur and it is certainly worth considering that when they come back, getting everything in order, 6 months may be, in fact, too short.

Mr. FEENEY. Well, I thought Mr. Delahunt's question—maybe I misunderstood it—went to the length of time of the 6-month average income requirement. Maybe I misunderstood.

Ms. SCHAKOWSKY. Yes. No, I think he was referring to—am I right about that—how long a Reservist or National Guardsman coming back could avail himself of this kind of protection.

Mr. WATT. If the gentleman would yield, that is what he intended, as he discussed with me before he left.

Mr. FEENEY. Well, that is what you get for asking questions that are over our head down here, but that is the only question I had. Thank you.

Ms. SÁNCHEZ. The gentleman yields back his time.

Does the gentleman——

Mr. FRANKS. Let me indulge to just ask one very brief question.

Ms. SÁNCHEZ. Procedurally, does the gentleman from Florida yield back the balance of his time?

Mr. FEENEY. I would yield to the Ranking Member, Mr. Franks.

Ms. SÁNCHEZ. Thank you.

Mr. Franks?

Mr. FRANKS. Thank you, Mr. Feeney. Thank you very much.

Just to touch briefly on the statement that I made related to the national security clearance, I am wondering if one or both of you might look into that to see if there is any way that we might make sure that we at least consider that possibility so that it does not do the harm that Mr. Cannon was concerned about. The concern is that——

Mr. ROHRABACHER. Certainly. And I do not know if that would be considered specifically germane to the bill or not because it might be from a different Committee or something like that. It might force this into another Committee.

Ms. SÁNCHEZ. It is probably within the jurisdiction of the Armed Services Committee and not the Commercial and Administrative Law Subcommittee.

Ms. SCHAKOWSKY. And the other thing about this is, look, those people who are forced into bankruptcy now are doing it under more adverse circumstances, but they are still being forced into bankruptcy. So they are losing their security clearance regardless under current circumstances. So this does not really change that in any way or exacerbate it any more than that. But, you know, so I think it is not necessarily relevant to this particular bill.

Mr. FRANKS. Thank you, Madam Chair.

I guess the only other thing that I would reiterate then is just it is difficult, but maybe we ought to talk about ways that we could work once again to help these service people in ways that might not, you know, include bankruptcy, but to still address the financial issue, and I know that the both of you are certainly inclined to that direction.

Mr. ROHRABACHER. I would certainly support any piece of legislation that you might want to bring up on that, and it probably would complicate this particular legislation because it would be sending it to different Committee jurisdictions.

Mr. FRANKS. All right. Thank you, Madam Chair. I yield back.

Mr. JOHNSON. Madam Chair——

Ms. SÁNCHEZ. The gentlemen——

Mr. FEENEY. And I yield——

Ms. SÁNCHEZ. The gentleman from Florida yields back his time.

And at this time, the gentleman from Georgia, Mr. Johnson, is recognized.

Mr. JOHNSON. Thank you, Madam Chair.

I have been asked by the Chairman of the full Committee, the Honorable John Conyers, Jr., to have his written statement inserted into the record.

Ms. SÁNCHEZ. Without objection, so ordered.

[The prepared statement of Chairman Conyers follows:]

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Statement of the Honorable John Conyers, Jr.
for the Hearing on H.R. 4044, to amend the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to exempt from the means test in bankruptcy cases, for a limited period, qualifying reserve-component members who, after September 11, 2001, are called to active duty or to perform a homeland defense activity for not less than 60 days

Tuesday, April 1, 2008, at 2:00 p.m.
2141 Rayburn House Office Building

It is no secret that I strongly opposed the bankruptcy legislation signed into law three years ago this month. In my judgment, the 2005 Bankruptcy Act favored credit card companies and corporations over ordinary consumers; it burdened honest debtors falling on hard times, often beyond their control, to the yoke of major new lifelong debts.

And it did nothing to meaningfully crack down on abusive lending practices. In fact, by giving lenders powerful new tools to cut their losses through heavy-handed pursuit of their borrowers in bankruptcy, in a very real sense it encouraged abusive lending practices.

Proponents of the 2005 Act claimed it was a fair compromise that only tightened the reins a notch on wealthy debtors. But as we are seeing, it actually gives creditors massive new powers to threaten low-income debtors. It permits creditors to reclaim common household goods that are of little value to them, but very important to the debtor's family, and makes it next to impossible for people to keep their house or their car in bankruptcy.

Proponents of the 2005 Act claimed it protected alimony and child support. But it actually goes in the opposite direction, creating major new categories of nondischargeable debt and thereby directly reducing the money available for alimony and child support.

At the same time, the 2005 Act did nothing to discourage abusive lending to under-age borrowers and nothing to discourage reckless lending to the developmentally disabled.

And, it did nothing to regulate the practice of so-called 'subprime' lending to persons with no means to repay their debts.

Today, at long last, we consider a bill that will provide some relief, for some people at least, from one of the Act's more onerous provisions – the means test that now forces many honest debtors into multi-year court-supervised payment plans, often with devastating results to the honest debtors and their families.

H.R. 4044 would exempt certain members of the National Guard and Reserve in active service from the means test if they have served for at least 60 days. The exemption is extended for 180 days after the member leaves service.

H.R. 4044 is a laudable bill, but I think it's a sad commentary on the state of our bankruptcy law. It's hard to believe that members of our armed forces who risk their lives in defense of our Nation must subject themselves to the means test in order to obtain financial relief from debt that very likely arose as a result of their service.

As for the larger need, correcting the extensive damage and unfairness resulting from the 2005 Act, I would call the bill before us **a good start**.

I commend my colleagues on both sides of the aisle – Jan Schakowsky from Illinois and Dana Rohrabacher from California – for their leadership on this important measure.

Mr. JOHNSON. Thank you. I yield back.

Ms. SÁNCHEZ. The gentleman yields back his time.

I would like to thank our first panel of witnesses for their hard work on this very important piece of legislation. We appreciate your time and your staying to answer questions.

And at this time, we will excuse our first panel, and we will take a brief recess to allow the second panel to come forward to the table.

[Recess.]

Ms. SÁNCHEZ. I am now pleased to introduce the witnesses for our second panel for today's hearing.

Our first witness is Raymond Kelley. Mr. Kelley is the national legislative director for American Veterans, known as AMVETS, at the AMVETS National Headquarters in Lanham, Maryland. He is responsible for the planning, coordination, and implementation of AMVETS' relations with the United States Congress and Federal departments and agencies and other organizations. He develops and executes AMVETS Washington agenda in areas of budget, appropriations, health care, veterans' benefits issues, national security, and foreign policy. Mr. Kelley's work also includes building relationships with other non-profit organizations and developing plans to promote veteran transitions to civilian life after their service.

Mr. Kelley served 6 years in the United States Marine Corps, he also served in the Army Reserve, and in April of 2006, he was deployed to Iraq as the Psychological Operations Team leader. Mr. Kelley serviced for 12 months in the base of the Sunni-Shiite triangle and continues to serve in the Army Reserve.

Welcome to you, Mr. Kelley.

Our second witness is Jack Williams. Professor Williams serves as the Robert M. Zinman Resident Scholar at the American Bankruptcy Institute and was also the inaugural ABI Resident Scholar when the ABI endowment fund created the program in 2001. As the ABI Resident Scholar, Professor Williams assists ABI with its educational programming and in its role as the authoritative source of bankruptcy information for the Congress, media, and public.

Professor Williams teaches at Georgia State University College of Law. He instructs an assortment of courses on bankruptcy and taxation. He also teaches at the New York Law School LLM program in taxation, the New York University School of Law continuing professional education program, the Internal Revenue Service, and the Federal Law Enforcement Training Center.

Welcome to you, Mr. Williams.

Our final witness is Ed Boltz who appears on behalf of the National Association of Bankruptcy Attorneys, NACBA. Mr. Boltz is a member of the law offices of John T. Orcutt, P.C., where he represents clients in not only Chapter 13 and Chapter 7 bankruptcies, but also in related consumer rights litigation, including fighting abusive mortgage practices.

In addition to serving on the board of directors for NACBA where he is jointly responsible for directing the State chair program, Mr. Boltz serves on the Bankruptcy Council for the North Carolina Bar Association and previously served as the bankruptcy chair for the

North Carolina Association of Trial Lawyers. Mr. Boltz moderated the panel Military Members Deep in Debt at the 2007 convention of NACBA.

I would like to welcome you all here today.

And at this time, I would invite Mr. Kelley to begin his testimony.

TESTIMONY OF RAYMOND C. KELLEY, NATIONAL LEGISLATIVE DIRECTOR, AMVETS, LANHAM, MD

Mr. KELLEY. Thank you, Madam Chair, Members of the Subcommittee. Thank you for inviting AMVETS to present our views today.

Ms. SÁNCHEZ. Pardon me, Mr. Kelley. Is your microphone on?

Mr. KELLEY. Yes, ma'am.

Ms. SÁNCHEZ. Can you move that a little bit closer?

Mr. KELLEY. Is this better?

Ms. SÁNCHEZ. That is much better. Thank you so much. We will restart your time.

Mr. KELLEY. Thank you.

Thank you, Madam Chair, Members of the Subcommittee, for holding this hearing today, and thank you for inviting AMVETS to present our views concerning H.R. 4044.

I want to start by saying AMVETS wholly supports H.R. 4044, but it was not until after we had a long debate within our office on the substance of this bill. But, at the end of the day, we decided that it was better for the veterans, so we had to do it.

My first reaction when I read this piece of legislation was: What does this say about our priorities as a Nation when the women and men of our National Guard and Reserve must have a provision enacted that will allow them to more easily file for bankruptcy if they have served on active duty? Why aren't we paying them enough to sustain their financial wellbeing? It was the basis of our debate. But, at the end of the day, we must do everything we can for our veterans and ease the pains of these noble citizens.

Currently, there are 18,252 National Guard and 8,288 Reserve members serving in Iraq, Afghanistan, and along our southern border in Operation Jump Start; 500,000 Guard and Reserve members have served in Iraq and Afghanistan since 2001, with 25 percent of those serving multiple tours. The Guard and Reserve was not developed to sustain this type of TEMPO, and it has only placed a greater burden on those who have served.

In my written testimony, I have provided a couple of tables to provide insight on the income deficits that the National Guard and Reserve face, and I put in there what Reserve members would receive if they lived in Illinois in the Springfield area and they deployed to Iraq, and it was about $47,000 a year. Now that did not include the combat pay and the tax breaks that they receive, which ends up being about $4,700 per year. But, at the end of the day, it is still about $10,000 less than what a person in Illinois would make on average with the same amount of time and service as in their civilian employment. So we are still $5,000 to $6,000 short on that deficit.

And those who serve stateside in support roles and those who are serving along the southern border do not receive the benefit of that

combat pay or the incentive of the tax exemption. This adds only to the financial hardship. The fact is that these 1-year tours generally end up being 16 months to 24 months, and during the time that they are mobilizing, they do not receive that combat pay or the tax incentive.

I will use myself as an anecdotal case. I served in Iraq. I started in April of 2006, but I started training to go to Iraq in November of 2005. So 5 months prior, I was committed to serving with the Army Reserve before I left and did not receive the incentive pay. And if I had to redeploy today, I would have to take an equity loan on my home to make sure that my family stayed at the same financial status and paid their bills, to sustain their way of life.

This financial hardship does not stop when they return. Many of these National Guard and Reservists are either full-time or part-time students and are trying to support a family, and when they leave to go on active duty, they have to disenroll from school and leave these part-time jobs, and when they return, they have to find new jobs and re-enroll to unsympathetic universities and employers. So it sets them back. These members have to pay to re-enroll to the same school that they were in, and then they have to re-apply for the G.I. bill which can take 3 months before they start getting paid again.

And many employers do not understand or adhere to the USERRA laws, making it difficult for Guard and Reserve members to return to the jobs that they have left. USERRA is in place to protect Guard and Reserve members from discrimination while they serve, but a 2002 report showed that USERRA violations increased by 35 percent in 2002 and each year subsequent after that, there has been a 10 percent increase.

It is important to do everything we can to protect and support our Guard and Reserve, and that is why AMVETS asks this Subcommittee to act positively on H.R. 4044.

And that concludes my testimony. I will be happy to answer any questions.

[The prepared statement of Mr. Kelley follows:]

PREPARED STATEMENT OF RAYMOND C. KELLEY

SERVING WITH PRIDE

AMVETS

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STATEMENT OF

RAYMOND C. KELLEY
AMVETS NATIONAL LEGISLATIVE DIRECTOR

BEFORE THE

HOUSE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

CONCERNING

THE AMENDMENT OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005, EXEMPTING CERTAIN GUARD AND RESERVE MEMBERS FROM THE BANKRUPTCY MEANS TEST

TUESDAY, APRIL 1, 2008
2141 RAYBURN HOUSE OFFICE BUILDING
2:00PM

Madam Chair Sánchez, Ranking Member Cannon, and members of the Subcommittee:

On behalf of AMVETS (American Veterans) I want to thank you for providing me the opportunity to testify before this Subcommittee concerning the proposed amendment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Public Law 1aw 109-8) as outlined in H.R. 4044.

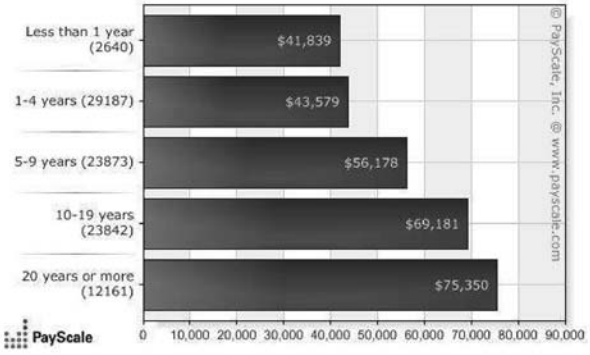
AMVETS strongly supports amending the Bankruptcy Abuse Prevention and Consumer Protection Act to exempt National Guard and Reserve members who have been called to active duty for no less than 60 days from the bankruptcy means test. Although bankruptcy should be used as a last resort to overcome accumulated debt, AMVETS realizes that Guard and Reserve members are frequently asked to accumulate debt when they deploy in service of the United States. These citizen warriors often serve in austere places around the world making less than they do in their civilian occupations. Extended or repeated deployments will require these servicemembers to rely on credit to support their families. All too often, these servicemembers return to civilian life either looking for suitable employment or dealing with an employer who either does not understand or disregards the laws pertaining to employees who serve in the military, all of this while they are trying to readjust to civilian life. This does not include those who suffer from the effects of combat that prevent them from providing for their families. These effects can be seen in the number of homeless veterans and the percentage of veterans who are unemployed. Removing the means testing for these veterans will help reduce the financial stresses that often complicate readjustment to civilian life.

Currently there are 18,252 National Guard and 8,288 Reserve members on active duty in support of OIF/OEF and Operation Jump Start along our southern border. Nearly 500,000 servicemembers from the Guard and Reserve have been deployed to Iraq and Afghanistan since 2001, with 25% of these servicemembers deploying more than once. The Guard and Reserve components of our military were not developed to sustain these types of missions over extended periods of time. It is a testament to the leadership of our Guard and Reserve forces and the

character of those serving in their ranks to be able to consistently sustain this mission tempo for six years. The stress associated with combat and leaving ones family is only aggravated by financial hardships that often accompany deployments.

On average Reserve members who have been employed for nine years in both their civilian occupation and in the Guard or Reserves and can expect to have an income deficient of nearly $10,000 over a one-year period. There will be a $2,700 combat pay and tax breaks while in the "Combat Zone" but these benefits are not present during mobilization or demobilization. With these statistics, it is easy to presume that Guard and Reserve members who are called to active duty will fall below the state average for income; therefore they would still qualify to file under Chapter 7 bankruptcy laws by not meeting the means test.

Average salary for residents of Illinois



Regular Military Compensation Calculator

http://www.payscale.com/research/US/State=Illinois/Salary

Results from Springfield, Il. Servicemember with 9 years of service at E-6 pay grade

Your Results		
	Monthly	Annual
Basic Pay	$2,607.60	$31,291.20
BAS	$294.43	$3,533.16
BAH	$887.00	$10,644.00
Cash Total	$3,789.03	$45,468.36
Tax Advantage	164.08	1,968.98
Regular Military Compensation	3,953.11	47,437.34

Office of the Secretary of Defense Military Compensation

http://www.defenselink.mil/militarypay/mpcalcs/Calculators/RMC.aspx

Adding to the financial hardship of being activated from Reserve to active duty status is the length of time these Guard and Reserve members are deployed. Currently, most deployments are predicted to be a one-year tour, but more often than not they turn into 16 to 24 month of activation. If a Guard or Reserve unit is projected to serve 12 months "boots on the ground" there are weeks and often months of pre-mobilization and training that must be validated prior to entering the combat zone and post-deployment de-mobilization that are hidden in these deployments.

Not only are some of these servicemembers taking a cut in pay, they also encounter employment discrimination for their service. The Uniformed Service Employment and Reemployment Rights Act (USERRA) provides employment and reemployment rights for members of the uniformed services, including veterans and members of the Reserve and National Guard. Under USERRA, service members who leave their civilian jobs for military service should be able to perform their

duties with the knowledge that they will be able to return to their jobs with the same pay, benefits, and status they would have attained had they not been away on duty. USERRA also prohibits employers from discriminating against these individuals in employment because of their military service. As outlined in the AMVETS sponsored "Symposium for the Needs of Young Veterans," USERRA reporting mechanism is inconsistent and complete understanding by servicemembers and employers of the Act is insufficient. In 2002 there was a 35% increase in USERRA violations with an approximate 10% increase in the years following. Now, compounding the fact many of these Reserve members are making less money, they may be returning to an employer who is violating their employment rights.

To add to the difficulties, the Employment Histories Report which was prepared by Abt Associates, Inc. for the Department of Veterans Affairs revealed startling facts about recently separated servicemembers. Eighteen percent of recently separated servicemembers, those who have separated within the past three years, are unemployed, 25% earn less than $21,849 per year. Using employment services of DoD, VA, or Department of Labor is not a strong predictor of successful employment transition. Nearly 49% of eligible servicemembers use some portion of their GI Bill Benefit and almost 29% use the Transition Assistance Program without an indication of higher earnings.

In addition the Employment Histories Report found that presenting one's self as a good candidate for employment when transitioning back to civilian life after military service is met with difficulties. Although servicemembers can tout positive attributes such as work ethic, discipline, leadership and integrity, employers often allow perceived negative attributes such as lack of specific business knowledge, being limited to taking orders, the risk of PTSD and other effects of combat to influence their decision-making when interviewing a servicemember for a specific position.

To assume veterans will use the lack of a means test to abuse the current bankruptcy laws is wrong. If we use delinquency of payments or foreclosure statistic as an indicator, veterans fare

Ms. SÁNCHEZ. Thank you, Mr. Kelley. We appreciate your testimony.

At this time, I would invite Professor Williams to proceed with his testimony.

Can you——

Mr. WILLIAMS. Excuse me. Thank you very much.

Ms. SÁNCHEZ. There we go.

TESTIMONY OF JACK F. WILLIAMS, SCHOLAR-IN-RESIDENCE, AMERICAN BANKRUPTCY INSTITUTE, ALEXANDRIA, VA

Mr. WILLIAMS. Madam Chair, Members of the Subcommittee, my name is Jack Williams, and it is a pleasure and honor to be here before you all today. As mentioned, I am a professor of law at Georgia State University College of Law in Atlanta, Georgia, and also the Robert M. Zinman American Bankruptcy Institute Scholar-in-Residence.

Today's subject is not new to me. For over 20 years now, I have devoted time to military personnel issues, including debt, payday loans, credit counseling, bankruptcy, and security clearance issues. Along with a colleague of mine, Susan Seabury of BDO Seidman, and a number of volunteer law students, I have represented on a pro bono basis several service members, mostly from the Georgia and the Southeastern Region, with serious and pressing financial issues. Recently, along with Ms. Seabury, I completed a research project and report on Debt, Bankruptcy and the Servicemember Civil Relief Act, which will be published by Norton's Annual Survey of Bankruptcy Law.

What I would like to do today is use my time to describe the scope of the legislation that is pending, how the bankruptcy process works with service members without the legislation, how it would work with the legislation, and then talk very briefly on some of the consequences of financial distress that our service members experience, including things like the potential possibility of criminal sanctions under the Uniform Code of Military Justice where the loss of security clearance is associated with not aggressively managing one's financial situation.

When we look at the scope of the legislation, we see that it is targeted, specific, and quite modest. In fact, it is very much an extension of what already exists under section 707 of the Bankruptcy Code. In particular, we already exempt from the presumption of abuse disabled veterans, but we would be essentially extending that exemption from the presumption of abuse of the bankruptcy process, which we commonly refer to as the means test. We would exempt that presumption of abuse in the context of activated Reservists and National Guardsmen, clearly the citizen soldiers of this country that we are talking about today, and there is a very short time window, a 6-month time window from their leaving active duty, that they could take advantage of this particular provision.

So we are talking about in the language itself very limited scope in its application, modest and targeted to address a particular issue, as the financial distress that is caused in part by activation of citizen soldiers for an extended period of time.

The other point I would like to make is that based on the most recent data, which would be about 2004 in a study by the Department of Defense, we see about 16,000 service member bankruptcy filings a year. That number has not been rolled forward to the present time period, but if one were to use the percentages that existed in 2004 and rolled it forward, we would probably be looking at somewhere between 18,000 to 20,000 bankruptcy filings by active duty service members.

Of that amount, there would be a smaller amount that would probably refer to Reservists and National Guardsmen, and we could estimate somewhere between 2,000 to 2,500 members that might be affected, Reservists and National Guardsmen, that may seek relief under this particular provision. And we might think that is not a very big number in the scheme of things, but, as my father taught me, sometimes it is the quality and not the quantity, that it is magnitude and not the quantity, and so there is a question of numbers that in the absolute or even relatively speaking might be very small, nonetheless, would be very important.

Now the way the means test works right now is that if someone's income is below the median income for that State, the means test will not apply. If it does apply, however, then the burden is upon the service member to rebut that presumption. If he rebuts that presumption, he has to do it usually in sworn testimony based on the facts and circumstances.

What this legislation would do is change that. The presumption would be not of abuse. The presumption would be that they would be eligible for the relief they sought, and if abuse was present, then the United States Trustee or another watchdog could challenge it and, ultimately, based on the facts and circumstances of each individualized case, can make a determination of whether the service member has abused the bankruptcy process. That does not change by the enactment of this particular bill.

I see I am out of time. Thank you very much.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF JACK F. WILLIAMS

Statement of Jack F. Williams

Before the House Judiciary Subcommittee on Commercial and Administrative Law

H.R. 4044

To amend the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to exempt from the means test in bankruptcy cases, for a limited period, qualifying reserve-component members

April 1, 2008

I. INTRODUCTION

Mr. Chairman and members of the Subcommittee, my name is Jack Williams. I am a Professor of Law at Georgia State University College of Law in Atlanta, Georgia, and currently the Robert M. Zinman Resident Scholar at the American Bankruptcy Institute (ABI). I am pleased to appear today to speak about pending legislation that would amend the Bankruptcy Code (the "Code") to help activated reservists and national guardsmen in the bankruptcy process through an exemption from the application of the means test found at Bankruptcy Code section 707(b).

Founded on Capitol Hill in 1982, the ABI is a non-partisan, non-profit association of over 11,000 professionals involved in bankruptcy and insolvency, representing both debtors and creditors in consumer and business cases. The ABI is not an advocacy group and does not take lobbying positions on legislation before Congress or advocate any particular result in matters pending before the courts. Rather, the ABI is a neutral source for information about the bankruptcy system (such as how courts are interpreting provisions of the Bankruptcy Code) and a resource for members of Congress and their staff considering changes to the Code. As an academic, and as the ABI resident scholar, I am permitted to give my personal views on legislation, but those views should not be taken as the views of the ABI.

At Georgia State, I teach and write primarily in the areas of bankruptcy law (including business and consumer bankruptcies), taxation, homeland security, and military law. My C.V. is Attachment 1 to this written statement, but let me briefly say that after graduating from George Washington University Law School, clerking for Judge William J. Holloway, Jr., of the U.S Court of Appeals for the Tenth Circuit, and working for four years in the Dallas, Texas office of Hughes and Luce, I joined the faculty of Georgia State University College of Law, where I have taught for the past seventeen years. For calendar year 2008, I am serving as the Scholar in Residence at the ABI in Alexandria, Virginia.

Today's subject is not new to me; for over twenty years I have devoted time to military personnel issues, including debt, payday loans, credit counseling, bankruptcy, and security clearance issues. Along with a colleague of mine, Susan H. Seabury of BDO Seidman, LLP, and several volunteer law students, I have represented on a pro bono basis several Servicemembers with serious and pressing financial issues. Recently, I, along with Ms. Seabury, completed a research project and report on *Debt, Bankruptcy and the Servicemember Civil Relief Act*, which

will be published by Norton's Annual Survey of Bankruptcy Law. I am also co-authoring a book on Bankruptcy and the Servicemembers Civil Relief Act set for publication this summer 2008.

As the Resident Scholar at the ABI, I have studied the pending legislation (and prior related bills) which exempts certain activated reservists and national guardsmen from the means test embodied in section 707 of title 11 of the United State Code, that is, the Bankruptcy Code.

My testimony today will focus on H.R. 4044. That proposed bill seeks to exclude activated reservists and national guardsmen from the means test found in Bankruptcy Code section 707(b).

First, I will discuss the concept and application of means testing as presently framed by Chapter 7 of the Bankruptcy Code. Second, I will discuss the special protections provided military personnel, especially in the areas of debt collection and bankruptcy. I will also address the national security concerns that military debt generates. Third, I will address the specific Bill before this subcommittee, the problem it addresses, the need for such a bill, and its internal harmony with other provisions of the Bankruptcy Code and the Servicemembers Civil Relief Act.

II. MEANS TESTING UNDER THE BANKRUPTCY CODE

On April 20, 2005, President Bush signed into law Senate bill number 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). BAPCPA is the most substantial revision of bankruptcy law since enactment of the Bankruptcy Reform Act of 1978. More specifically, BAPCPA dramatically changed several aspects of individual consumer bankruptcy law and, for the first time, imposed what is commonly known as a "means test" to determine individual consumer debtor eligibility for relief under chapter 7 of the Bankruptcy Code. BAPCPA generally became effective as to cases filed on or after October 17, 2005.

A. Types of Consumer Bankruptcy Cases

Although an individual debtor may commence a case under chapter 11 of the Bankruptcy Code, the vast majority of cases filed by individual consumer debtors are under either chapter 7 or chapter 13.

1. Chapter 7

A bankruptcy case under chapter 7 of the Bankruptcy Code is a liquidation. Often, you hear lawyers refer to chapter 7 cases as "straight" bankruptcies. Generally, all of the debtor's non-exempt assets are collected by the chapter 7 trustee (who is always appointed by the U.S. Trustee) who identifies, collects, liquidates, and distributes them. Importantly, a debtor's postpetition income earned from services personally performed is not property of the estate, that is, most postpetition income remains with the debtor and is not used to satisfy prepetition claims. The proceeds from non-exempt assets are distributed to the various creditors who filed a proof of claim before the deadline known as the bar date.[1] The assets claimed as exempt by the debtor

[1] See 11 U.S.C. § 726 (2006).

are retained by the debtor for a fresh start.[2] The case is closed once the estate is fully administered.

For the individual debtor, the ultimate goal of a chapter 7 case is an order of discharge, which discharges the debts owed by the debtor to the creditors that arose before the order for relief and enjoins the creditors from ever collecting on their discharged claims from the debtor.[3] Chapter 7 discharges are reserved for individuals; partnerships and corporations may not receive a chapter 7 discharge.

For the creditors, the ultimate goal of a chapter 7 case is the efficient collection, liquidation, and distribution of estate property in satisfaction of allowed claims. The distribution of estate property to satisfy allowed secured and unsecured claims is made in accordance with the distributional scheme embodied in the Bankruptcy Code.

2. Chapter 13

Chapter 13 is limited to individuals with regular income who meet certain debt limits.[4] A chapter 13 case is in some ways similar to a chapter 11 case in that the goal of a chapter 13 case is rehabilitation of the debtor and not liquidation. The debtor keeps all the assets, exempt and non-exempt, and attempts to make payments pursuant to a chapter 13 plan or schedule of payments over three to five years. Further, a chapter 13 trustee operates as the disbursing agent, distributing estate property, including disposable income, in accordance with the terms of the chapter 13 plan. Essentially, the debtor makes one payment to the chapter 13 trustee who then divides that payment by the debtor into many small payments to the creditors. The chapter 13 plan is generally funded through the debtor's postpetition disposable income. The concept behind chapter 13 is that a debtor with significant postpetition income should use a portion of that income over three to five years to pay back a significant portion of his prepetition debt.

B. What does the means test do?

The means test is found in section 707(b) of the Bankruptcy Code.[5] That section was amended to provide for dismissal of chapter 7 cases or conversion to chapter 13 (with the debtor's consent) upon a ***finding of abuse*** of the bankruptcy process by an individual debtor with primarily consumer debts. There are two ways to find abuse. First, abuse may be found through an unrebutted presumption of abuse, arising under a new means test. Second, abuse may be found on general grounds, including bad faith, determined, after notice and hearing, under the totality of the circumstances.

The presumption of abuse, set out in new § 707(b)(2), is triggered by a means test, designed to determine the extent of a debtor's ability to repay general unsecured claims. The means test has

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[2] See 11 U.S.C. § 522 (2006).
[3] See 11 U.S.C. §§ 727, 524 (2006).
[4] 11 U.S.C. § 109(e) (2006).
[5] For an excellent discussion of means testing and some of the present problems in its application, see Eugene R. Wedoff, *Major Consumer Bankruptcy Effects of BAPCPA*, 2007 Illinois L. Rev. 31. I highly recommend Judge Wedoff's writings in the consumer bankruptcy area.

three elements: (a) a definition of "current monthly income," measuring the total income a debtor is presumed to have available; (b) a list of allowed deductions from current monthly income, for purposes of support and repayment of higher priority debt; and (c) a defined "threshold of abuse," at which the income remaining after the allowed deductions would result in a presumption of abuse.[6] Practice under the Bankruptcy Code has established that the application of the means test is a complex process and has increased the costs of chapter 7 bankruptcy representation.

The other basis for a finding of abuse, applicable under § 707(b)(3) where the presumption does not apply or has been rebutted, is that the debtor filed the petition in bad faith, or that the totality of the debtor's financial circumstances indicates abuse. The U.S. trustee, bankruptcy administrator, or judge can assert this basis for finding abuse in any case; creditors and case trustees are limited to asserting it in cases where the debtor's income is above the defined state median. The totality of circumstances test is a fact-specific inquiry. Under this approach, a bankruptcy court holds an evidentiary hearing to determine whether, under all the facts and circumstances of the case, a debtor is acting in bad faith or abusing the bankruptcy process and should be denied chapter 7 relief or, with the debtor's consent, the case should be converted to chapter 13 of the Bankruptcy Code.

C. Who can challenge abuse of the bankruptcy process?

Section 707(b)(2)(C) requires debtors to file a statement of their calculations under the means test as part of the schedule of current income and expenditures under section 521. If the presumption arises, the court is required to notify creditors within ten days of the filing of the petition.[7] In addition, the U.S. trustee or bankruptcy administrator is required to review the debtor's materials and file with the court, within "10 days after the first meeting of creditors," a statement as to whether the presumption of abuse arises. A copy of the statement must be provided to all creditors by the court. If the presumption arises, the U.S. trustee or bankruptcy administrator must file either a motion under §707(b) or a statement explaining why the motion is not being filed.[8]

Section 707(b)(1) generally allows *any party in interest*, as well as the court on its own initiative, to bring a motion seeking dismissal of a chapter 7 case for abuse. However, there are significant limitations to this broad standing provision. Section 707(b)(6) provides that only the judge, U.S. trustee or bankruptcy administrator may bring the motion if defined "current monthly income" or "CMI" does not exceed a defined state median.[9] Moreover, under section 707(b)(7), the means test presumption is completely inapplicable to debtors if defined CMI is below that median. In addition, section 707(b)(2)(D) makes the means test inapplicable to certain disabled veterans.

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[6] Eugene R. Wedoff, *Major Consumer Bankruptcy Effects of BAPCPA*, 2007 Illinois L. Rev. 31.
[7] *Id.*
[8] *Id.*
[9] *Id.*

D. How is the means test applied?

To apply the means test, courts look at the debtor's current monthly income, which is the average income for the six months prior to filing, and compare it to the median income for that state. Specifically, "Current monthly income" is defined in section 101(10A) as a monthly average of all the income received by the debtor (and the debtor's spouse in a joint case)—including regular contributions to household expenses made by other persons, but excluding benefits under the Social Security Act and certain victim payments—during the six month period ending with the last day of the calendar month preceding the filing, as long as the debtor files a Schedule I (Statement of Current Income). Thus, for example, if a bankruptcy case were filed in March, as long as the debtor filed Schedule I, current monthly income would be the average monthly income received by the debtor during the preceding September through February.[10]

For example, the median annual income for a single wage-earner in Georgia is $36,412. If the income is below the median, then Chapter 7 remains an option. If the income exceeds the median, the remaining parts of the means test are triggered and must be considered.

Under section 707(b)(2)(A)(i), two situations exist that may trigger the means test presumption of abuse. First, if the debtor has at least $166.67 in current monthly income available after the allowed deductions ($10,000 for five years), abuse is presumed regardless of the amount of the debtor's general unsecured debt. Second, if the debtor has at least $100 of such income ($6,000 for five years), abuse is presumed if the income is sufficient to pay at least 25% of the debtor's general unsecured debt over five years.

In summary, under the means test, a Chapter 7 filing is presumed to be abusive if the debtor's monthly income, reduced by numerous allowances and living expenses, and multiplied by 60 (that is, over a five-year period), is greater than $10,000. If income thus adjusted is less than $6,000, there is no presumption of abuse, and the debtor is free to choose Chapter 7, unless under the totality of the circumstances, the debtor is nonetheless abusing the bankruptcy process. If adjusted income is between $6,000 and $10,000, abuse is presumed only if income exceeds 25% of nonpriority, unsecured debt in the case. An abusive Chapter 7 filing is subject to dismissal or conversion.

E. How is the presumption of abuse rebutted?

A Chapter 7 petition by a debtor who passes the means test is presumed to be abusive. To rebut the presumption, section 707(b)(2)(B) requires that a debtor prove under oath that "special circumstances" exist.[11] These special circumstances are such that their existence would decrease income or increase expenses so as to bring the debtor's income after expenses below the trigger points. The law also provides that this presumption may be rebutted by demonstrating other forms of "special circumstances," such as a serious medical condition or a call to active duty in the Armed Forces, which justify additional expenses or adjustments to current monthly income. The emerging view among bankruptcy courts is that "special circumstances" is generally strictly construed.

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[10] *Id.* However, if the debtor failed to file Schedule I, then the six-month period would end on the date that the court determines "current monthly income."

[11] *Id.*

III. SERVICEMEMBER RELIEF

Great sacrifices are made by the men and women who serve honorably in our armed services protecting this Nation. Along with the sacrifices of military personnel, a servicemember's dependants sacrifice mightily as well. At least since the Civil War, Congress and many states have enacted remedial legislation designed to protect "those who dropped their affairs to answer their country's call."[12] In one of the earliest cases relating to the Soldiers and Sailors Civil Relief Act ("SSCRA"), (amended and renamed the Servicemembers Civil Relief Act ("SCRA") in 2003), the Supreme Court, in *Boone v. Lightner*,[13] noted: "The Soldiers' and Sailors' Civil Relief Act is always to be liberally construed to protect those who have been obliged to drop their own affairs to take up the burdens of the nation."[14] This allows the servicemember to devote his/her "...entire energy to the defense of the nation"[15] in a manner "...unhampered by obligations incurred prior to their call."[16]

In response to the financial distress placed on personnel by the call up of the Reserves and the National Guard in Operation Enduring Freedom (OEF) and Operation Iraqi Freedom (OIF), Congress enacted the SCRA, a broad ranging remedial act designed to protect those who protect the Nation, which in many instances enlarged protections that existed under the SSCRA.

When it comes to servicemember protection or special dispensation, we do not approach a clean canvas. There is a long history of protecting servicemembers that reaches deep into the early years of this country. Moreover, although servicemember protection was heralded as a noble act of a grateful country, even the most ardent advocates recognized that servicemember protection must be balanced against legitimate judicial process.

Protective legislation began in the town that gives us Mardi Gras. During the War of 1812, as the British marched toward New Orleans, Louisiana promulgated its stay law, staying civil actions for four months during hostile activity.[17] During the Civil War, the federal government and some states also enacted legislation staying actions to which a member of the armed forces was a party.[18] These Civil War era provisions were generally tied to times of active combat. The purposes of these early attempts to protect servicemembers centered on building and maintaining an army and navy during time of war, reducing distractions of those who served, and protecting the integrity of the civil judicial process. Thus, the dual purposes of establishing and maintaining a military force whose members may devote their complete attention to protecting this country and of protecting the integrity of the civil judicial process remain stable directional points in our application and understanding of the SCRA to bankruptcy and financial distress issues.

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[12] LeMaistre v. Leffers, 333 U.S. 1, 6 (1948).
[13] 319 U.S. 561, 63 S.Ct. 1223, 1231, 87 L.Ed. 1587
[14] Boone, 319 U.S. at 575, 63 S.Ct. at 1231.
[15] Engstrom v. First National Bank of Eagle Lake, 47 F.3d 1459, 1462 (5th Cir.1995)
[16] Omega Industries, Inc. v. Raffaele, 894 F.Supp. 1425, 1434 (D.Nev.1995).
[17] H.R. Rep. 108-81, 2004 U.S.C.C.A.N. 2367, 2377.
[18] *Id.*

The ABI is in the process of developing materials to guide the bankruptcy professional in providing aid to servicemembers who may, or may not, fully understand their rights and protections. Further, the ABI is also in the developmental stages of a program to provide assistance to these servicemembers on a *pro bono* basis.

A. Military Personnel Debt Loads

There is a serious military personnel debt problem that transcends the traditional debtor/creditor issues we regularly face. For example:

- **56%** of enlisted military personnel report difficulty with family finances. *(Military Family Research Institute)*
- **47%** of members say they are in "over their head" with their own expenses. *(Military Family Research Institute)*

The Department of Defense ("DoD") has been aware of the pressing financial situation of military personnel for over a decade and as taken steps, along with Congress, to help remedy some of the problems and abuses associated with debt shouldered by military personnel. Two DoD surveys conducted in 1997 and 2002, respectively, showed that more than a quarter of service members had financial problems. The 1997 survey found 27 percent of servicemembers had trouble paying their bills and 21 percent reported being called by bill collectors. Nine percent had pawned valuables and 4 percent reported having utilities disconnected, had cars and trucks repossessed, or had to declare bankruptcy. The 2002 study found that one in four junior military members had serious problems making ends meet. Another 4 percent regarded themselves as "in over their heads" financially. About 20 percent of military members reported being pressured by creditors -- about twice the rate of civilians polled in the same survey. Twenty-seven percent of military members said they had trouble paying bills, compared to 19 percent of civilians. The credit problems were worse in the Army and Marine Corps. The Air Force had the fewest problems. The Navy estimated it lost $250 million in productivity and salary losses because of poor financial management by service members.

The Congress has recognized this problem by providing certain remedies and protections. Congress has capped the interest rate on payday loans to military personnel. Congress has substantially amended the SCRA to cap the interest rate on certain debts, to prevent foreclosure, and to stay administrative and judicial proceedings. And, in the Bankruptcy Code itself, Congress has identified as "special circumstances" activation to active duty of personnel of the Armed Forces and has presently exempted from the means test certain disabled veterans.

B. Security Clearances at Risk

One of the biggest reasons for concern beyond the traditional debtor/creditor scenario is the security risks associated with bad credit. Presently, the military uses 13 guidelines to determine initial and continued eligibility for access to classified information. Any soldier, sailor, marine, or airman with a shaky financial history could be considered unreliable or untrustworthy and therefore a security risk. Thus, indebtedness is a rationale for revocation or denial of a security clearance.

The number of security clearances of Sailors and Marines revoked or denied due to financial problems has soared from 124 in 2000 to 1,999 in 2005. The six-year total was 5,482, a 1512.1% increase in the number of clearances lost. In 2006, the number of clearances lost was approximately 2,654. Easily, the primary reason military personnel lose their security clearance is financial difficulty.[19] Thus, high levels of debt are costing thousands of military personnel their security clearances and preventing them from serving critical duty. Defense officials say the increase in security denials has not undermined the military's fighting ability, even as U.S. troops are stretched thin in Iraq and Afghanistan. They acknowledge, however, that it has complicated the job of assembling some critical combat units.

Because of the consequences of excessive debt, particularly a debt level from about 30% to 40% of income, many servicemembers do not aggressively address their debt issues. For a servicemember, debt is not only a personal financial issue; it may also be a career killer.

IV. THE PROPOSED LANGUAGE AND EFFECT

The stated purpose of the bill before you today is to amend the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to exempt from the means test in bankruptcy cases, for a limited period, qualifying reserve-component members who, after September 11, 2001, are called to active duty or to perform a homeland defense activity for not less than 60 days. The class of potential debtors sought to be protected by this bill is targeted and consists of citizen soldiers who have answered their country's call to service. The new text will read:

> **(E)** Subparagraphs (A) through (C) shall not apply, and the court may not dismiss or convert a case filed under this chapter based on any form of means testing--
>
> **(i)**
>
> **(I)** while the debtor is on, and during the 180-day period beginning immediately after the debtor is released from, a period of active duty (as defined in section 101(d)(1) of title 10[20]) of not less than 60 days; or
>
> **(II)** while the debtor is performing, and during the 180-day period beginning immediately after the debtor is no longer performing, a homeland defense activity (as defined in section 901(1) of title 32[21]) performed for a period of not less than 60 days; and
>
> **(ii)** if after September 11, 2001, the debtor while a member of a reserve component of the Armed Forces or a member of the National Guard, was called to such active duty or performed such homeland defense activity.[22]

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[19] *Seapower,* June 2006.

[20] The term "active duty" means full-time duty in the active military service of the United States. Such term includes full-time training duty, annual training duty, and attendance, while in the active military service, at a school designated as a service school by law or by the Secretary of the military department concerned. Such term does not include full-time National Guard duty.

[21] The term "homeland defense activity" means an activity undertaken for the military protection of the territory or domestic population of the United States, or of infrastructure or other assets of the United States determined by the Secretary of Defense as being critical to national security, from a threat or aggression against the United States.

[22] I would re-write this provision by striking current section (ii) and renumbering (i)(I)-(II) and (i) and (ii).

The scope of this bill is limited to include only our "citizen soldiers" – those who had "real lives" they left to answer their country's call. Many of these brave men and women not only left their families and put their very lives on the line, they took a substantial cut in pay as well. A quick review of the pay tables for the military shows that the annual pay of the rank and file of those who protect us most assuredly cannot be called "highly compensated." Further, while the SCRA does provide some protections, the suspension of foreclosure and the 6% interest rate cap do little to make up for the loss of gross income. Further, in the case of small businesspersons, these protections do not prevent the failure of a business of which the servicemember is the key if not sole employee. For these men and women, not only do they in fact suffer a substantial cut in pay, they face the loss of a business they may have spent years growing.

In my personal opinion, what this bill does is to tell these servicemembers that they do not have to hold on and deal with the pressures of creditors and the risk to their security clearance until the "taint" of their significantly better paying civilian job is removed from the rolling six month calculation. Further, it says we respect the honor you have shown by your service and give you the benefit of the doubt with regard to whether you would lower yourself to "abuse" the system. Yes, military service is among the "special circumstances" that can rebut the presumption of abuse, but that presumption is still there and the servicemember must pay counsel out of funds he or she does not have to rebut that presumption.

There are those who say, but what about the servicemember who can afford to repay a portion of his or her debts through a chapter 13? This bill does not foreclose a finding of abuse that would require a debtor to convert from a chapter 7 to a chapter 13 through section 707's other provisions. Rather, it simply says in appreciation for your honorable service, we are not going to ask you to jump through these additional hoops and bear the burden of being presumptively abusive, rather we are going to give you the benefit of the doubt and require the United States Trustee or the court on its own motion to bring up the issue of abuse only if it is warranted by the facts and circumstances of each individual case.

V. CLOSING REMARKS

This Country asks much of its military personnel and their dependents. In order to protect those who protect this Country, while simultaneously protecting the integrity of the bankruptcy system, the bill is designed to provide procedural protections to servicemembers who seek relief under chapter 7 of the Bankruptcy Code. The bill presumes that activated reservists and national guardsmen that file a chapter 7 petition have filed their petitions in good faith. It would then be incumbent upon certain parties in interest, including the U.S. trustee, and the bankruptcy court, to object to chapter 7 relief. A court could then determine in an individualized manner whether, under the totality of the circumstances, a reservist or national guardsmen has engaged in abuse of the bankruptcy process. The bill appears to strike a pragmatic balance to ensure that the bankruptcy process does not unfairly disadvantage our Nation's citizen soldiers.

* * *

Thank you again for the opportunity to appear today. Please do not hesitate to call upon me or the ABI if we can be of further assistance on this or any other bankruptcy policy issue.

Ms. SÁNCHEZ. Thank you for your testimony.

At this time, I would invite Mr. Boltz to proceed with his testimony.

TESTIMONY OF EDWARD C. BOLTZ, THE LAW OFFICES OF JOHN T. ORCUTT, P.C., DURHAM, NC, ON BEHALF OF THE NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Mr. BOLTZ. Chairwoman Sánchez and Members of the Subcommittee, I thank you for inviting me to speak before you on H.R. 4044, which would exclude Reservists and military National Guard members serving on active duty from the means test under the Bankruptcy Code.

As a consumer bankruptcy attorney in North Carolina, I have the privilege of representing military service members from the Fort Bragg area as well as Reservists and National Guards throughout serving from North Carolina. I have also had the privilege of speaking on military matters previously and have some acquaintance with the security issue that Mr. Franks has raised also.

The means test, as enacted by the Bankruptcy Abuse and Consumer Protection Act of 2005, enacts some mechanical calculation of a debtor's ability to repay their debt and whether they are entitled to a discharge in Chapter 7 and, if they are in a Chapter 13 bankruptcy, how much they are required to pay to their creditors in that case.

The starting point for this mechanical calculation is what is called their current monthly income. This is a historical amount which looks at the 6 months preceding the filing of the bankruptcy to determine what the debtor's income is going forward for their bankruptcy case, either Chapter 7 or Chapter 13.

Because of the nature of military service, upon returning from overseas, a service member is likely to face not only a loss of their military income, which is heightened in cases where they served in a combat zone by not only their imminent hazard pay, but also by a family separate allowance, and also basically a cashout for a per diem allowance for their daily pay of about $3.50 over a 15-month period of time. That is almost $1,600, however.

These amounts heighten a debtor's current monthly income which bears no relation to their actual income upon return home which may be less, it may be more, it may be nothing based on their work situation. They, nonetheless, face difficulties with the bankruptcy. They would be subject to a presumption of abuse or a requirement that they pay that money which does not actually exist in the Chapter 13 case.

In some cases, this has caused clients of mine to have to wait for a period of as long as 6 months to file a bankruptcy. In some circumstances, this involves just gritting their teeth and getting through 6 months of phone calls and collection attempts from their creditors. Where the debtor is facing foreclosure, repossession, or garnishment of their wages, this is time that they cannot wait, however, and the peculiarities of the means test are not something they can wait to sort themselves out.

This is particularly true for those in the military who not only face the normal debt collection difficulties, but they face possible

court martial under the Uniform Code of Military Justice for dishonorably failing to pay their debt and also threats of loss of security clearance.

These are problems that exist regardless of the bankruptcy and, in many instances, the bankruptcy prevents these problems. Routinely, we have soldiers—and I say soldiers, but this would true for all branches of the military—where their commanding officers have, in fact, advised them to file bankruptcy to avoid prosecution or other disciplinary problems.

We believe that H.R. 4044 is a very narrow and modest approach to this problem. It is similar to the approach taken for disabled veterans that Representative Rohrabacher mentioned previously, and military Reservists would still be subject to court review under a totality of the circumstances, tests in the Bankruptcy Code, and in a Chapter 13, they would still be s subject to a good faith test that their case was filed in good faith and they were making an attempt to repay their debt in an appropriate manner, returning them, in effect, to the pre-2005 statue.

Lastly, at a time of war, H.R. 4044 would further the laudable and important goals of the Servicemembers Civil Relief Act, which provides for strengthening and expediting the national defense, by removing this as a distraction for our service members and removing it from the calculus in deciding whether they can afford to serve.

Thank you for your time.

[The prepared statement of Mr. Boltz follows:]

PREPARED STATEMENT OF EDWARD C. BOLTZ

Written Testimony

of

Edward C. Boltz, Esq.
On behalf of
National Association of Consumer Bankruptcy Attorneys

Before the
United States House of Representatives
The Subcommittee on Commercial and Administrative Law

H.R. 4044, the 2005 Bankruptcy Act and active duty military

April 1, 2008

Chairman Sánchez, Ranking Member Cannon and Members of the Subcommittee, thank you for the opportunity to testify before you regarding the need to enact H.R. 4044, which would exclude debtors currently serving on active duty in the military from the Means Test under the bankruptcy code.

I am a consumer bankruptcy attorney in private practice in North Carolina, where my bankruptcy practice includes the representation of military personnel and their families stationed primarily at Fort Bragg, as well as members of the military, reserves and National Guard residing elsewhere in North Carolina. I am a certified specialist in consumer bankruptcy law by the North Carolina State Bar Board of Legal Specialization and the American Board of Certification and I serve on the Board of Directors of the National Association of Consumer Bankruptcy Attorneys (NACBA). I received my J.D. from the George Washington Law School and my B.A. from Washington University. At the 2007 Convention of the National Association of Consumer Bankruptcy Attorneys I moderated the panel discussion, entitled "Military Members Deep in Debt," which addressed the unique issues facing military service memberswho are in debt and in need of the bankruptcy safety net.

In 2005, Congress passed, and President Bush signed into law, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA , among other substantial changes, required consumer debtors to pass a rigorous "Means Test" in order to obtain a discharge in a Chapter 7 proceeding or to determine the amount to be repaid to creditors in a Chapter 13 case. The purpose of the Means Test was to create a standardized, almost mechanical, review of a debtor's income and expenses. The first step in the application of the Means Test is a calculation of a debtor's "Current Monthly Income," based on the income received by the debtor in the six (6) months preceding the filing of the bankruptcy petition. As "Current Monthly Income" is an historical average of a debtor's income, rather than a reflection of his or her actual income at the time the case is filed, it has been frequently remarked that "'Current Monthly Income' may be neither current, monthly, nor income."

It is from the starting point of the Current Monthly Income" that a debtor's permissable standardized expenses are deducted, determining whether a debtor qualifies for a discharge in a Chapter 7 case or the amount that must be repaid to creditors in a Chapter 13 case. When there is a discrepancy between a debtor's actual income and "Current Monthly Income," a debtor may be denied a discharge or required to pay income that is no longer actually received.

This discrepancy, between a debtor's actual income and his "Current Monthly Income" may result from a change in employment, medical distress, etc. Of particular relevance to consideration of H.R.4044, such a discrepancy between actual income and "Current Monthly Income" can often arise for members of the military, particularly when they return from combat duty overseas. While serving in an "imminent danger pay zone," most notably including Iraq and Afghanistan, a service member is entitled to an additional $225.00 per month for "Hostile Fire and Imminent Danger Pay." In addition to combat pay, service members in combat zones generally are not required to pay

income taxes. While serving in a combat zone, members of the military who are separated from their spouse or children, also are entitled to an additional $250.00 a month. And upon conclusion of their tour of duty in a combat zone, a service member also receives $3.50 per day for compensation for incidental expenses. With a 15-month tour of duty, this would result in income of $1,575.00. When a service member returns from such combat duty, these additional compensations terminate.

It is, however, precisely after returning from overseas, that a service member may face the greatest need of seeking bankruptcy protection. Upon return, the service member also may have to bear many of his own living expenses, such as food, clothing, housing, etc., which were covered by the military while overseas. Furthermore, the stresses and rigors of long deployments overseas all too often leave service members facing additional pressures once they return home, including personal, marital and psychological difficulties, which often result in additional expenses and financial problems. It is these issues that often press those military members into filing bankruptcy following their return from combat duty.

By looking back at a debtor's income over a period of six (6) months, however, service members may find themselves on the horns of a dilemma - their "Current Monthly Income" will include not only the combat pay, but also a *per* diem, family separation allowance, and the lack of taxes, but their actual income will not include any of these additional amounts. They may be ineligible for a bankruptcy discharge or forced to file a Chapter 13 bankruptcy, which requires them to pay their creditors "disposable income" which they do not actually have. The result of this discrepancy is that service members must often wait up to six (6) months to seek bankruptcy protection, as their "Current Monthly Income" comes back into line with their actual income.

In some cases, this may result in a debtor having to just grit his teeth and live through the harassment of creditors for several months. When facing foreclosure, garnishment or repossession of an automobile, however, waiting may simply not be possible, since any delay may result in the loss of a debtor's home, car or income.

This is compounded by a gap between the protections of the Bankruptcy Code and the Servicemembers' Civil Relief Act ("SCRA"), found at 50 U.S.C. §§501-596. The SCRA will generally provide service members with a stay against all legal proceedings, including foreclosures, for up to 90 days following termination of active duty, if such duty impedes the service member from appearing at such proceeding. This leaves a gap of three (3) months between when the protections of the SCRA terminate and those of the Bankruptcy Code become fully available, during which the service member may be subject to substantial risk.

Additionally, service members face a risk from their creditors that civilians generally do not. Article 134 of the Uniform Code of Military Justice makes it a crime for a service member to dishonorably fail to pay a debt. (In most instances, filing bankruptcy is not considered a dishonorable failure to pay debts, as is it allowed by federal law.) The threat of facing a court martial, whether overt or implied, will often override any delay required by the oddities of the Means Test.

Admittedly, some bankruptcy courts that have faced this quandary have found ways to provide relief to service members. Primary among these has been to find that the reduction of the service member's income constituted a "special circumstance" that rebutted any presumption of abuse in a Chapter 7 or excused the payment of nonexistent income in a Chapter 13. The difficulty with this solution, however, is that it is both unpredictable and, because the finding of "special circumstance" requires extensive evidentiary hearings, also involves increased cost to the already bankrupt service member, in terms of both attorneys fees and time by the service member, time that distracts the service member from his responsibilities defending the Nation.

Accordingly, H.R. 4044 is an appropriate, modest and narrowly tailored response to this problem. This provision would not be radical departure from the Means Test as enacted under BAPCPA, as it would be substantially similar to those in 11 U.S.C. § 707 (b)(2)(C), which excuses disabled veterans, with some qualifications, from application of the Means Test.

H.R. 4044 also would exempt only service members on active duty and for a period of 180 days thereafter from the Means Test. Once their "Current Monthly Income" is no longer artificially inflated with combat pay, service members who are not on active duty to the Mean Test, would again be subject to the Means Test. Further, even those service members excluded by H.R. 4044 from being subjected to the Means Test, would still be subject to scrutiny by the bankruptcy court under §707 (b)(3) as to whether their bankruptcy demonstrates an abuse and under the good faith requirements of Chapter 13.

Lastly, at a time of war, H.R. 4044 would further the laudable and important goals of the Servicemembers Civil Relief Act of strengthening and expediting the national defense by enabling service members to devote their entire energy to the defense needs of the Nation, by providing temporary suspension of the Means Test, as the application of the Means Test may adversely affect the bankruptcies of service members during their military service.

Ms. SÁNCHEZ. Thank you, Mr. Boltz.

We will now begin with questioning, and I will begin by recognizing myself for 5 minutes.

Mr. Kelley, we tried to have a member of the National Guard or the Reserve to testify at today's hearing, but we encountered a high degree of reluctance to do so. Can you explain to us why that was so?

Mr. KELLEY. I ran into the same problem. After I found out that your office was having a difficult time finding someone, I put a search out, and I think you would find it in any segment of society, it is not just exclusive to people in the military, that admitting your financial difficulty in a public forum is very difficult, and you do not want that to be part of the public record. I would assume that you would want to secretly put all of this behind you and try to move forward. So rehashing it or making it on a public forum would be very difficult.

Ms. SÁNCHEZ. Right. We actually encountered in another hearing that we did on USERRA in another Subcommittee that I serve—the difficulty of people not wanting to malign the military or say anything that might be construed as maligning the military and a huge degree of reluctance on the part of service members who are experiencing financial difficulty to actually talk in an open forum about it.

Professor Williams, Bankruptcy Code section 707(b)(2)(D) already provides an exception to the means test for a disabled veteran whose indebtedness was primarily incurred while on active duty, and as you stated, H.R. 4044 would just add a further limited exception for certain qualifying members of the National Guard and the Reserve. Do you see any reason why this further exception could be problematic by extending it to these Reservists?

Mr. WILLIAMS. No. The proposal is a modest extension of existing law and would be consistent with the general structure of the means test and the presumption of abuse, the totality of circumstances test, and finding abuse would be consistent and in harmony with most provisions of the Bankruptcy Code as well as the Servicemembers Civil Relief Act.

Ms. SÁNCHEZ. And because we are dealing with presumptions, there still is discretion on the part of a bankruptcy judge to look at a case and find that there is, in fact, any kind of abuse, even though this exemption would exist presumably if we enacted it.

Mr. WILLIAMS. Absolutely. In fact, failing the means test that otherwise would not apply could be a factor that a court considers under the totality of the circumstances. It just means that the presumption is not a presumption against the service member. The presumption would be the presumption in favor of the service member seeking relief, and it would be incumbent on any party and interest to challenge the debtor's eligibility to proceed under Chapter 7.

Ms. SÁNCHEZ. Thank you.

Mr. Boltz, you assert that the means test presents particular difficulties for members of the military who have received combat pay. Why can't the service member simply explain that his or her temporary receipt of a higher income is a special circumstance?

Mr. BOLTZ. Chairwoman Sánchez, they can do that. One of the difficulties with that is that it is both an unpredictable outcome and a costly outcome. It is unpredictable in terms that the service member would have the burden of rebutting the presumption which is not something taken lightly by courts and would place the burden on someone who has already borne a burden overseas for this Nation. And it would be costly both in terms of additional costs for paying their attorney for this representation and also in terms of their time spent in the hearings that would ensue on this.

In special circumstances, the case law that has developed since 2005 on this has held that it is a very high standard for special circumstances, not something that can be rebutted easily, and this would entail, in my experience, a hearing that would last the better part of a day for a debtor which, again, dovetails with what Mr. Kelley previously testified, which also carries with it the stigma and embarrassment that someone would have.

When people file for bankruptcy, one of the main things they look to me as their attorney for is to tell them what is going to happen, and, right now, when it comes to this sort of thing, I can tell them, you know, "You are throwing yourself on the mercy of a court," which is not a palatable answer.

Ms. SÁNCHEZ. Not a very pleasant thing to do.

H.R. 4044 is the bill that has been proposed, and it is limited to members of the National Guard and the Reserve. Do you think it should apply to other members of the military?

Mr. BOLTZ. I do think that other members of the military who have returned from combat duty face similar difficulties with this. So I would urge the Committee to consider that. That would be a vast expansion of what is right now a pretty narrow bill because, again, upon returning from active combat duty in Iraq or Afghanistan or other combat zones, a regular military service member would face a reduction in their income, and for a period of 6 months, that would prejudice them in a bankruptcy proceeding, but, you know, with this narrow bill as it is, I believe it is appropriate.

Ms. SÁNCHEZ. Thank you, Mr. Boltz.

My time has expired.

At this time, I would recognize the gentleman from Arizona, Mr. Franks, for 5 minutes.

Mr. FRANKS. Well, thank you, Madam Chair.

I thank all of you for being here today.

Mr. Boltz, I am really impressed with your knowledge here. All of you. But I do not even think you read your statement, did you?

Mr. BOLTZ. No, I did not, sir.

Mr. FRANKS. Yes, sir. Well, some of us have to have a script for everything.

Some argue that the means test already gives a break to those who are earning less than the applicable State median income and those in special circumstances. If that is the case, isn't this bill potentially aimed at benefiting the wealthier Reservists and the Guardsmen who do not present special circumstances, like the colonels and not the privates, and do we take that into account.

And, Mr. Boltz, I will——

Mr. BOLTZ. Mr. Franks, it is true that in a Chapter 7 proceeding, those who are below the State median income are not subjected to the means test. They are still subjected to the totality of the circumstances abuse case which would be the same following this amendment.

However, in a Chapter 13 proceeding, debtors are subject to the means test whether they are above or below the median income because this means test is what is used to determine how much a debtor has to pay to their unsecured creditors in a Chapter 13 case. And for many service members who are returning, if they are facing foreclosure or repossession of a car, Chapter 7 does not stop those proceedings, would not save their home or their car, and they are forced to turn to Chapter 13.

And that is where more and more debtors, particularly in the current economy, including military debtors, are forced to go, and even when they are below that median income, the amendment would protect them from having to pay income that they no longer have.

Mr. FRANKS. Sometimes, you know, we forget to ask a salient question. If you were trying to improve this legislation or if you could do one thing to address the underlying purpose of the legislation, what would you do to make it better? Do you have any thoughts about how we could either improve this legislation or to address the soldiers' issues in a better way?

And, Professor Williams, I might ask you first and let the others address it as they will.

Mr. WILLIAMS. Thank you, Mr. Franks.

We should recognize that any bankruptcy answer is the second best solution, that it only applies after service members are in financial distress—and serous financial distress—so that any modification to the Bankruptcy Code only solves a very small problem of what is a much larger problem.

The much larger problem here is military personnel debt load, and we are talking about a very large problem. Fifty-six percent of enlisted military personnel report difficulty with family finances, and 47 percent of service members say they are in over their head with their own expenses.

Now this is a modest proposal, but I would suggest that we think broader at some particular point in time and look at the overall problem that service members face in regard to financial debt. Congress has done a number of things, amending the Servicemembers Civil Relief Act, capping the interest rate on payday loans, a number of things, and is moving, I think, to a more holistic and robust view.

I would applaud what Congress has done in the past and suggest that that is the appropriate road and the long-term road to resolve the issues of financial distress and the negative consequences, not only the human toll, but the toll on one's profession because there are serious security clearance consequences associated with financial distress in the military that may foreclose one's career and service in the military as well.

Mr. FRANKS. Mr. Kelley, do you have any thoughts there?

Mr. KELLEY. Yes. About the first question, I do not think anybody in the military would abuse this because of the fact of what

we mentioned about the security clearances and how it will affect their career. And the only people that could really abuse it, in my estimate, are officers and higher enlisted people who have decided to make this a career. So they would, in essence, be ending their career to file for bankruptcy, especially if it was unneeded.

To improve this bill, I think the only thing that I would consider, because I like the narrow scope of it, is active duty military personnel who have been extended to go to Iraq or Afghanistan, and when they come back, they are immediately separated. So they are, in essence, unemployed when they return to the United States and have not had a chance to look for employment, look to get into a college, to do all the things that the rest of us do to network when we move from one career field to another. That opportunity is not afforded to them. So I would consider adding those who are separated immediately from active duty to this bill.

Mr. FRANKS. Thank you, Madam Chair.

Thank you, all of you.

Ms. SÁNCHEZ. Mr. Boltz, did you want to respond to that question?

Mr. BOLTZ. I would just second Mr. Delahunt's suggestion that perhaps it be extended from 180 days to 1 year for both technical reasons. Strictly speaking, the means test does not look at the last 6 months. It looks at the last 6 months preceding the filing. So if you file a case on the last day of a month, say you filed yesterday, it would not look at 6 months before March 31, it would look at February, January, December and back for 6 months. And also for practical reasons, someone, as was just stated, leaving the military, it takes a little while to get back on your feet and get, I guess, your land legs back under you under civilian law.

Ms. SÁNCHEZ. Yes, I noticed some head-shaking. Mr. Kelley and Mr. Williams, do you agree with the suggestion of extending that to 1 year?

Mr. KELLEY. AMVETS would agree.

Mr. WILLIAMS. Personally, I would agree with that suggestion.

Ms. SÁNCHEZ. Thank you.

The gentleman's time has expired.

At this time, I would recognize Mr. Johnson for 5 minutes for questions.

Mr. JOHNSON. Thank you, Madam Chair.

Professor Williams, last October, this Subcommittee conducted an oversight hearing on the United States Trustee program, and according to Director Cliff White's testimony, approximately .63 percent of consumer cases are ultimately dismissed for abuse under the new means testing criteria. This means that well less than 1 percent of Chapter 7 cases are dismissed for abuse, even though proponents of these reforms claimed that the percent was likely to be 10 times higher. Given the complexity and cost of implementing the means test, what value does it actually provide?

Mr. WILLIAMS. As a general question, it provides, I think, two things.

Primarily, it is a statement to the government that those who have the ability to pay substantial amounts of future income to reduce the significant portion of debt should do so and that the government has identified that as a good.

And, second, it suggests to those who are contemplating bankruptcy that may tend toward abuse that this will not be a welcome forum or venue and, therefore, the number, although it may be perfectly accurate, may actually undercount potential abusers who believe that they will be ferreted out and caught if they file a bankruptcy petition and purport to abuse the system.

Whether that, in fact, outweighs the increased level of complexity and cost that a large number of people have to incur is another question, and whether government should in drafting legislation of a remedial nature should presume for any section of its citizenry abuse is also another question. But I think there are some advantages, there are some benefits, to a means testing mechanism. Whether this is the right way is subject to debate based on its complexity and increased costs and the results that you have identified.

Mr. JOHNSON. Mr. Boltz, what would be your response?

Mr. BOLTZ. In regards to the benefits that the means test provides?

Mr. JOHNSON. Yes.

Mr. BOLTZ. From my clients' point of view and from mine, the main benefit that has resulted from the means test is that most of my clients, again, look to me for predictability, and this provides a means where I can tell them, you know, largely what will happen to them in their bankruptcy case by using a standardized mechanical test. It is harsh on many people who do not fit that test, and it also requires people not to be able to file perhaps when they need to. They may have to wait for after a deployment or after their unemployment has lasted a period of time.

Mr. JOHNSON. It actually increases the attorneys' fees that are charged to people who would otherwise be looking to file a Chapter 7, and it thrusts probably more people into pro se status trying to file Chapter 7s. Would you agree to that?

Mr. BOLTZ. I would agree. I would agree with both the attorney fees and, anecdotally, I will say there are more people who file pro se Chapter 7s, yes.

Mr. JOHNSON. And do you agree, Professor Williams, as well?

Mr. WILLIAMS. Yes, I do on both points.

Mr. JOHNSON. Yes. How long would it take a pro se debtor to complete means test form 22, which consists of 52 sections?

Mr. BOLTZ. Well, with the assistance of counsel, you——

Mr. JOHNSON. Well, I mean, a pro se——

Mr. BOLTZ. A pro se debtor——

Mr. JOHNSON. A pro se without assistance.

Mr. BOLTZ. Without assistance, I would honestly say that many would not be able to complete it. For me to do it, it requires a computer program because the numbers shift as they adjust. So, for a pro se debtor, it would take probably 10 to 12 hours, I would expect, to gather the information and complete that based on the amount of time it takes with my assistance. On every case, we probably spend upward of two to 3 hours completing it.

Mr. JOHNSON. Okay.

Professor Williams?

Mr. WILLIAMS. I would agree with that assessment. It is a complex process.

Mr. JOHNSON. So, given the fact that only 1 percent or less than 1 percent of the filings result in a dismissal based on abuse, it just appears that this means test may not be a good thing, especially for our service men and women who are both active duty as well as Reserve and National Guard who come back and are separated and then encounter financial problems based on their being deployed.

So I know we are not going that far with this limited proposal here, but this limited proposal seems to certainly provide some relief to a key constituency that needs protection. So thank you.

Ms. SÁNCHEZ. The time of the gentleman has expired.

Mr. Keller is recognized for 5 minutes for questions.

Mr. KELLER. Thank you, Madam Chairwoman.

Professor Williams, you teach bankruptcy law. Is that right?

Mr. WILLIAMS. That is correct.

Mr. KELLER. Mr. Boltz, you are a practicing bankruptcy lawyer?

Mr. BOLTZ. That is correct.

Mr. KELLER. Were you both here for the testimony of Congressman Rohrabacher?

Mr. BOLTZ. Yes.

Mr. WILLIAMS. Yes.

Mr. KELLER. You may recall him saying that he felt he was misinformed when he was told by someone that essentially the provisions that this bill has are not needed because they are redundant, and I imagine what he meant by that is it was already covered by the special circumstances provision. Do you recall that?

Mr. BOLTZ. That is what I understood him to say.

Mr. KELLER. Well, as a practicing bankruptcy lawyer and a bankruptcy professor—and we will start with the lawyer—give us on this Committee an idea as to why the service men exempted by this legislation do not already qualify for relief under the means test special circumstances provision.

Mr. BOLTZ. Under the means test special circumstances provision that would be used by someone in a Chapter 7 case to rebut the presumption of abuse that had arisen because they had failed the means test in essence under 707(b)(2), the difficulty that that presents is that it, as I said earlier, again turns that case back to the bankruptcy judge on a subjective basis to determine the military debtor's circumstances and what their ability to pay would be based on their previous income.

Mr. KELLER. You are concerned that the judge would not rule favorably for the Reservists or Guardsmen under this objective test?

Mr. BOLTZ. In my experience, the bankruptcy judges I appear in front of in North Carolina, which are several, have obviously shown a great deal of deference and concern for military debtors in the past. They are a heroic segment of our society, and they have gotten that deference.

But even if there were a finding that there were special circumstances that justified a bankruptcy discharge, it is nonetheless a grueling proceeding. Generally, I have not faced one on this issue because we have——

Mr. KELLER. You say a grueling procedure, like a day-long evidentiary hearing?

Mr. BOLTZ. A day-long evidentiary hearing and also substantial pretrial discovery on this. And the court officials who are in essence the prosecutors, whether it is the U.S. Trustee or North Carolina where we have the bankruptcy administrators, they do not generally just stick to the issue of you are in the military. They dig into every aspect of the debtor's finances.

Mr. KELLER. So, while the Reservists or Guardsmen may ultimately prevail in front of a sympathetic bankruptcy judge, they would incur substantial litigation costs and attorneys fees by going through the process of proving that they qualify for the special circumstances?

Mr. BOLTZ. Yes. And, again, both the litigation costs and the time for themselves, which, again, as they are trying to get back on their feet and find their way back into civilian society is something that they can ill afford.

Mr. KELLER. I see.

Professor Williams, do you have anything to add as to why the special circumstances provision is inadequate under the circumstances to protect the Reservists and Guardsmen?

Mr. WILLIAMS. I would add that from a descriptive perspective that these situations present themselves while a Reservist or a Guardsman is actually on active duty. That would require, in some instances, courts conducting a telephonic hearing with service members stationed in Iraq or Afghanistan or other areas across the world. That adds to the complexity of the determination under the totality of circumstances test, notwithstanding the special exception.

Mr. KELLER. Okay. Mr. Kelley, do you have a sense of how many Reservists and Guardsmen are facing insolvency by their calls to active service?

Mr. KELLEY. The National Guard put out an estimate that 40 percent of all Guardsmen are in some sort of financial hardship. To what degree, they do not describe, but——

Mr. KELLER. Let me fire off a quick question before my time expires to you again, Mr. Kelley. I heard you mention something about concerns about veterans coming back from Iraq and Afghanistan being able to go to college and having other similar opportunity. Is it your view that we should somehow update or expand the G.I. bill to provide for more generous college opportunities, and if that is your view, do you want to tell us any specific bills or proposals you think that Congress should put on the front burner?

Mr. KELLEY. Yes. AMVETS wholly supports S. 22, Senator Webb's post-9/11 G.I. bill reform.

Mr. KELLER. Thank you, Mr. Kelley.

My time has expired.

Ms. SÁNCHEZ. The time of the gentleman has expired.

Mr. Watt is recognized for 5 minutes for questions.

Mr. WATT. Thank you, Madam Chair.

And let me start by just saying to Mr. Kelley, I can understand the vexing that AMVETS had to go through about this. We share those concerns that service people should not be in the position of having to deal with this, but, unfortunately, that is not currently the case. So I applaud your decision to, after going through that debate internally, provide your support for the bill.

In addition to Mr. Delahunt's comment about extending the term to a year at least or more or something longer than 6 months, certainly, the one concern I expressed about the bill was that it does not seem appropriately titled. I hope that Professor Williams and Mr. Boltz will take a close look at the way the bill is described.

I do not think it was the actual body of the bill itself accomplishes what I think was intended, but the way it is described to create an exemption from the means test I do not think is the appropriate thing that we are doing because the means test is a good thing and we are not trying to exempt people from it. We are trying to give them a benefit of it, regardless of their income levels, as I understand it.

So we need a better description for the bill in the preamble, I guess, it would be or in the title to the bill, and I hope you will give us some suggestions on that. I do not expect you to do that. I know you did not come to talk about the packaging today. You came to talk about the substance, but it does need to be packaged correctly, too, and titled correctly, and both Mr. Rohrabacher and Ms. Schakowsky acknowledged, after I raised the issue with them, that they do not have a good title for the bill, and so if you all could help us with that, I think that would be non-controversial in a markup of the bill, as might extending the term from the 6-month term to 12 months.

Other than that, I think the bill is fine and appreciate your all's support and input, and I am hopeful that this is something that we can do on a bipartisan basis and help our service people. And then we can turn our attention to the real problem, which is trying to solve their financial issues that will prevent them and others from getting into situations where they have to pursue this last resort, bankruptcy.

I heard Professor Williams' comment that when you are here, you have already reached the end of the road and we need to try to prevent more people from being here and reaching the end of the road, service people and non-service people, and we are trying to address a number of those issues as we go forward.

So thank you. I did not ask any questions. I just made my opening statement, I guess. But if you all have got a question that you want to answer, I will give you the rest of my time to answer it or I will yield it back.

Ms. SÁNCHEZ. Any takers?

Mr. WATT. In that case, I yield back.

Ms. SÁNCHEZ. The gentleman yields back the balance of his time.

I want to thank the witnesses for their testimony today.

Without objection, Members will have 5 legislative days to submit any additional written questions which we will forward to the witnesses and ask that you answer as promptly as you can so that they can be made a part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any additional materials.

Again, I want to thank everybody for their time and their patience, and this hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 3:34 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

ANSWERS TO POST-HEARING QUESTIONS FROM THE HONORABLE JANICE SCHAKOWSKY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Questions for the Record by Ranking Member Chris Cannon,
Subcommittee on Commercial and Administrative Law,
"Hearing on H.R. 4044," Tuesday, April 1, 2008, 2:00 p.m., 2141 Rayburn

Questions for Rep. Jan Schakowsky:

1. What reports are you hearing from your constituents about reservists and guardsmen being forced into bankruptcy by their call to active service?

My office has been working closely with the Illinois Department of Veterans Affairs to address the issue of veterans returning home and facing financial problems. My staff has personally spoken to several members of the Guard and Reserve who have returned home and had to file for bankruptcy or who are on the brink of filing.

One example is Jeremy W., a member of the National Guard who, like so many others, does not want to be identified because of the stigma surrounding financial distress. Jeremy was deployed to active duty in Iraq from March 2006 to June 2007. After he returned, he didn't want to be away from his wife, 4 year-old daughter and 7 year-old son, so instead of returning to his previous job as a truck driver, he took a lower-paying job. Jeremy now works 6 days a week to pay the bills and is teetering on the brink of losing his house.

The many hardworking caseworkers at the ILVA report that hundred of veterans like Jeremy come to them struggling to make ends meet, unable to find jobs with salaries equivalent to what they earned before service, or with unanticipated events during service that hurt them financially.

2. Is it sufficiently clear to whom this legislation would apply? Some have suggested that it may be read expansively to cover all members of the active duty military, if not others. Is that the intent? If not, would you agree that we should consider revising the language to make it clearer on this point?

This legislation was specifically drafted by my colleague Rep. Dana Rohrabacher to address members of the National Guard and Reserve because they are often the hardest hit financially by service. The bill would not affect any other members of the military.

3. Do you believe that we should try first and foremost to find proactive solutions that keep reservists and guardsmen out of the financial straits that produce bankruptcy, particularly given the potential impacts of bankruptcy and debt status on servicemen's security clearances?

It is vitally important that we help members of the Guard and Reserve before they reach the point of bankruptcy. I support legislation to provide members of the Guard and Reserve, along with other servicemembers, with comprehensive educational benefits, medical care, and assistance finding jobs when they return from service.

However, we cannot ignore the problem of guardsmen and reservists who must file for bankruptcy when they return home – those who are serving now, and those who already have or who will shortly return home from their service. We must do everything we can to ensure that these heroes do not face greater expense and lost time if they must enter bankruptcy proceedings.

According to the National Guard, four out of 10 members of the Reserves and National Guard lose money when they leave their civilian jobs for active duty. This is especially true for servicemembers who own and operate small businesses. These entrepreneurs put their businesses on hold, sometimes sacrificing them altogether, while they serve their country. Additionally, many members of the Guard and Reserves leave for the war thinking they will only be deployed for 6 to 12 months, and end up staying for fifteen months. There is almost no way that they can anticipate or and prepare for that extension of their service financially.

4. Some read this legislation to exempt from the means test anyone who has ever been called to active duty from the reserves or the Guard -- forever. There is the suggestion, for example, that if someone joins the reserves at age 18 in July 2015, is called to active duty a few years later, leaves the military in 2025, and files for bankruptcy in 2055 for reasons having nothing to do with military service, the person would be exempt from the means test. Is that the intent? If not, would you agree that we should consider revising the language to make it clearer on this point?

The legislation clearly states that a member of the Guard or Reserves who files for bankruptcy would be exempt from the means test for only a period of 180 days when they return from active duty. This time period was lengthened to 18 months in the Subcommittee on Commercial and Administrative Law's markup yesterday, and I support that change.

As all three witnesses at the Commercial and Administrative Law Subcommittee attested to at the legislative hearing on H.R. 4044 on April 1, 2008, extending the post-service period in which the means test exemption applies is prudent. Many servicemembers face financial distress for up to two years following separation from service, and providing the exemption for 180 days is not sufficient to capture those members of the Guard and Reserve who face financial distress due to service.

5. This bill has a retroactive effective date to April of 2005. How would this bill apply to cases that were filed before the date of enactment, many of which have been completed, with a resulting discharge from bankruptcy?

The bill was originally drafted before the *Bankruptcy Abuse Prevention and Consumer Act* became law in 2005, and it is my understanding that at that time the intention was for the exemption in H.R. 4044 to take effect at the same time as the changes to bankruptcy law. However, because the changes to the 2005 law have already taken effect, the bill's retroactivity was removed in yesterday's Subcommittee on Commercial and Administrative Law markup. H.R. 4044 will not affect any cases filed before the date of enactment.

ANSWERS TO POST-HEARING QUESTIONS FROM THE HONORABLE DANA ROHRABACHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Questions for the Record by Ranking Member Chris Cannon,
Subcommittee on Commercial and Administrative Law,
"Hearing on H.R. 4044," Tuesday, April 1, 2008, 2:00 p.m., 2141 Rayburn

Questions for Rep. Dana Rohrabacher:

1. What reports are you hearing from your constituents about reservists and guardsmen being forced into bankruptcy by their call to active service? What are you hearing about the depth and breadth of the problem nationwide?

   I make it a point, whenever I am able, to greet our brave veterans as they step off the plane in my district. I am often told by those National Guard and Reservist members that the unforeseen length of active duty they are called to after 9/11 negatively affects their finances. Various news articles have also covered the financial difficulty facing today's veterans. Exact numbers are difficult to obtain, however it is my belief that it is more than just a small handful.

2. Is it sufficiently clear to whom this legislation would apply? Some have suggested that it may be read expansively to cover all members of the active duty military, if not others. Is that that the intent? If not, would you agree that we should consider revising the language to make it clearer on this point?

   The intent of the bill is to apply the proposed modifications only to members of the National Guard or Reservists that have been called up since September 11, 2001, not the entirety of the Armed Forces. If that is not sufficiently clear, I would support clarifying language.

3. Do you believe that we should try first and foremost to find proactive solutions that keep reservists and guardsmen out of the financial straits that produce bankruptcy, particularly given the potential impacts of bankruptcy and debt status on servicemen's security clearances?

   Yes, staying out of bankruptcy entirely is, of course, preferable for everyone involved, but that does not mean that H.R. 4044 is not needed for those for whom bankruptcy become unavoidable.

4. Some read this legislation to exempt from the means test anyone who has ever been called to active duty from the reserves or the Guard -- forever. There is the suggestion, for example, that if someone joins the reserves at age 18 in July 2015, is called to active duty a few years later, leaves the military in 2025, and files for bankruptcy in 2055 for reasons having nothing to do with military service, the person would be exempt from the means test. Is that the intent? If not, would you agree that we should consider revising the language to make it clearer on this point?

The bill was written such that a reservist or national guardsman is only exempt for the period of 180 days from the date they are released from active duty. If the guardsman is called up again, the six month period begins again upon their return from the subsequent tour of active duty. While I am open to lengthening the exemption window, perhaps to a period of two years, it was not my intent to make this a life long exemption, and I would support clarifying language if necessary to carry out the intent.

5. Ch. 7's means test was at the heart of the consumer bankruptcy reforms enacted in BAPCPA. Do you believe that we should be vigilant against attempts to chip away at the means test? If so, what are the limiting features of your bill? What additional limiting features should we consider?

   The reason I introduced this bill in the 109th Congress, and am supporting it now is because I believe this narrow and targeted exemption should have been included in the House passed BAPCPA. I was told, at the time, that BAPCPA already included a special circumstances provision that covered the National Guard and Reservists. Upon review, I have concluded that I was misled. This bill was written only to rectify that mistake. I do not support any other changes to the applicability of the means test. H.R. 4044 is narrowly targeted only to members of the National Guard and the Reservists who after 9/11 have faced increased financial difficulty because of the needed increase in their service. Additional limited features may include adding various findings, or moving the provision such that it appears in the Bankruptcy Code after Senator Durbin's exemption for disabled veterans.

6. This bill has a retroactive effective date to April of 2005. How would this bill apply to cases that were filed before the date of enactment, many of which have been completed, with a resulting discharge from bankruptcy?

   I believe that those National Guard and Reservist veterans that have cases pending, or have had their cases closed since the retroactive effective date, should be given an opportunity to reopen their cases, if they desire to do so. I am open to the possibility of a different effective date.

ANSWERS TO POST-HEARING QUESTIONS FROM RAYMOND C. KELLEY, NATIONAL LEGISLATIVE DIRECTOR, AMVETS, LANHAM, MD

Questions for Raymond Kelley
From Linda T. Sánchez, Chair

1. **Please explain why National Guard and Reserve members accumulate debt when they are called to active service.**

Guard and Reserve members earn a living through civilian occupation and like most people they live a quality of life that their financial status will allow. In many cases when they are called to active duty their income will drop.

2. **How do you respond to opponents of H.R. 4044 who say that it will give servicemembers a free pass to avoid having to repay their debts?**

It is AMVETS understanding that the bill will not give a free pass only moves the burden of identifying the ability to re-pay to the court system. AMVETS believes most members of the service avoid because of the increased stigma that having financial difficulties bear.

3. **What is the impact of being activated on a Reservist or National Guard member who is a sole proprietor of a business?**

The impact could be devastating. As a sole proprietor a business owner relies on the work they perform to sustain their income and costumer base. While they are activated they will not only lose the income they will lose the costumer base they had developed over the years. This could cause carryover once the servicemember returns from service in financial loss as they try to rebuild their customer base.

4. **Aside from H.R. 4044, could the National Guard and the Reserve do more to help their members better deal with the financial impact of their service?**

Aside from informing the members of the interest rate reduction and credit protection laws that are in place to assist it is hard to prepare members for having their income reduced by a deployment. This should be a concern to the Department of Defense and pay increase should be implemented to bring military pay to an equal level with the civilian population.

AMVETS response to Questions for the Record by the Ranking Member, Chris Cannon, Subcommittee on Commercial and Administrative Law, "Hearing on H.R. 4044," Tuesday, April 1, 2:00 p.m., 2141 Rayburn

1. **How many reservists and guardsmen are brought closer to insolvency by their calls to active service?**

   This number is hard to calculate. It would be my assumption that the number would be in the hundreds.

2. **What other policies does AMVETS advocate to help reservists and guardsmen stay clear of precarious debt burdens or avoid financial difficulties if they're called to active service?**

   AMVETS conducts pre-deployment "workshops" at National Guard and Reserve units prior to deployment. AMVETS ensures the deploying members understand their rights under Chap 43, Title 38 U.S.C. (USERRA). Also, AMVETS informs members of their rights to have their interest rates reduced to 6% and that they can breach certain contracts because of their deployment. However, none of this advice can prevent insolvency when the Guard or reserve member's cost of living is higher than what their military pay check will cover.

3. **Does your organization believe it has a special obligation to counsel, advocate for, and otherwise help reservists and guardsmen manage their affairs so that the service they obviously want to give to their country doesn't threaten to ruin them financially? If so, please describe the activities that the organization pursues.**

   See answer to question #2.

4. **Even if a reservist or guardsman gets into Chapter 7 instead of Chapter 13, he or she is still significantly damaged – for example, by the black mark on their credit rating that will stay their for many years and the potential loss of their security clearance. Are there other, better things we should be focusing on first and foremost to help reservists and guardsmen?**

   When I first read H.R. 4044 my initial reaction was the bill was sidestepping the larger problem that many of our Guard and Reserve members face, that is the pay they receive from our government to protect our nation is not enough. With that said AMVETS feels that if we are going to fund a war we must fund the war fighters.

5. **Is it your intention to support the rollback of the means test for all members of the armed forces, or do you intend only to seek an amendment to the means test for this very special group of servicemen and –women**

AMVETS only supports this rollback for Guard and Reserve members who have been called to active-duty. The rationale is that these servicemembers are the only class of servicemember who is at risk of having wages reduced by being called to active duty.

6. **How many service members would be subject to the means test? In other words, how many earn an income above the applicable state median?**

   Currently there are approximately 536,260 members of the National Guard and reserve. Of that number approximately 198,730 are at a pay grade that would place them above the state average for Illinois. This number was arrived at by taking the average income for a family of two in Illinois, which is 54,979 and taking the income of an active duty servicemember with a family of two in Illinois, plus the incentive pay for being in a combat zone and finding the cutoff for the state average. Most Staff Sergeants and below would be below the average while in the theater of operations.

7. **Some argue that the means test already gives a break to those earning less than the applicable state's median income and those in "special circumstances." If that's the case, wouldn't this bill's effects provide disproportionate benefits to wealthier reservists and guardsmen who don't present special circumstances? How do we take that into account?**

   This argument assumes that the veteran would file for bankruptcy only because of the rollback of the means test. AMVETS does not believe that would be the case. Also, there will still be a burden of proof that will have to be met by all who file for bankruptcy.

8. **The means test is designed to ensure that people with above average income repay at least the portion of the debts that they are capable of repaying. What is the social impact if people with above average incomes who have an ability to repay at least some of their debts are permitted to discharge even those debts that they can repay? Who foots the bill for those discharged debts? What are the potential impacts on the cost of credit to reservists and guardsmen on transferring that bill to creditors?**

   It is AMVETS' understanding that is change will not automatically give Guard and Reserve members a free pass to bankruptcy, it will just place the burden of identifying the ability to repay on the court and not on the servicemember.

ANSWERS TO POST-HEARING QUESTIONS FROM JACK F. WILLIAMS, SCHOLAR-IN-RESIDENCE, AMERICAN BANKRUPTCY INSTITUTE, ALEXANDRIA, VA

Questions for Professor Jack Williams
American Bankruptcy Institute Robert M. Zinman Scholar in Residence
From Linda T. Sánchez, Chair

Madam Chairwoman Sánchez, thank you for the opportunity to respond further to additional questions you have submitted on behalf of the Subcommittee. Below are my answers to your specific questions. If you have any additional questions or comments, please do not hesitate to contact me.

1. **Some have expressed concern that H.R. 4044 will encourage debtors to load up on debt to take advantage of the limited exception from the presumption of abuse under Bankruptcy Code section 707(b). What is your response to that concern?**

   My experience as both an academic and practitioner would suggest that the likelihood of a servicemember both (1) being aware of the "means test," let alone the exceptions to that test and (2) successfully manipulating that test by loading up debt to take advantage of the limited and targeted exception is highly unlikely. Most servicemember debtors have incurred debt, like most non-servicemember debtors, without much consideration paid to potential bankruptcy relief. In the rare case where a servicemember has "loaded up" on debt in anticipation of using the proposed exemption under H.R. 4044, federal law would have three responses, none of which is remotely palatable to the servicemember. First, the proposed exemption operates as an exception to the presumption of abuse where the means test is satisfied; the exemption does not fashion an exemption from the abuse provisions entirely. In effect, the exemption shifts the burden of proof from the servicemember to the United States Trustee (U.S. Trustee) or Bankruptcy Court. Upon a proper objection by the U.S. Trustee, a court will consider abuse under the totality of the circumstances. The law should make clear that otherwise satisfying the means test should remain a factor in a court's consideration of abuse under the totality of the circumstances. Moreover, the Schedule of Liabilities filed by a debtor with his petition will show the prepetition "loading up" of debt, permitting the U.S. Trustee or Bankruptcy Court to make the proper objection. Second, "loading up" on debt in an effort to manipulate the bankruptcy system would result in the suspension and denial of a security clearance, thus resulting in the potential foreclosure of one's career. The denial of a security clearance must be disclosed on many job applications in civilian life as well. Third, the manipulation of debt as described in this question would most likely constitute a violation of the Uniform Code of Military Justice, subjecting the servicemember to a range of very unpleasant sanctions.

2. Approximately how many servicemembers and veterans would benefit from H.R. 4044?

Presently, there is no good recent source on the number of servicemembers who would benefit from H.R. 4044. However, I was finally able to track down some statistics from the Department of Defense (DoD) and RAND. According to the DoD, the total number of active duty military personnel (including activated reservists and guardsmen beyond training tours) filing for bankruptcy relief during calendar year 2004 was approximately 16,000 or about 1.2% of all bankruptcy filings. Thus, the statistics reflect bankruptcy rates well before the 2005 Amendments were enacted. That is the most recent information I have been able to locate. However, using a common statistical estimator, if you roll that number forward, with a few adjustments, we are looking at an estimate of anywhere between 18,000 to 35,000 total servicemember filings per year with the number probably closer to about 20,000. No reported numbers break down the rate of reservists and guardsmen *viz* regular military in that estimated 20,000 filings for calendar year2008. Again, if we apply the percentage of activated reservists and guardsmen to the general numbers above, we are looking at about 1,300 to 2,000 (with an aggressively high estimate of 2,500) reservists/guardsmen likely to file for bankruptcy relief in 2008. It is my opinion that these estimates are probably high in that, according to the RAND study, about 17% of reservists activated experience a drop in pay; 83% actually see their pay increase. Anecdotally, these numbers seem to square with the experience of bankruptcy practitioners and judges that I have canvassed on the subject.

3. H.R. 4044 presently extends the exception from the presumption of abuse under Bankruptcy Code section 707(b) for six months after the debtor leaves active service. Please explain whether this period is sufficient?

It is my experience that 6 months from leaving active duty is too short a time period in these circumstances. I assume that the 6-month time period was designed essentially to expunge the effect of service on the calculation of Current Monthly Income under the present version of the means test. However, there is another role that the 6-month window plays. It sets the time period by which, as a practitioner, I must be confident that any nonbankruptcy alternative debt repayment plan will work or I will commence a case on behalf of my servicemember client if I am to take advantage of the exemption in H.R. 4044. Ironically, a short period will actually increase the premature filing of bankruptcy cases in an effort to employ the exemption under H.R. 4044 even where, if given time, the debtor may have been able to workout its debt in a consensual context. Moreover, a 6-month period does not allow an attorney to assess whether a small business debtor may make a go of it without bankruptcy relief because one cannot get through one business cycle. For example, a servicemember who once operated a lawn care service may return to no customer base and increased costs due to restarting the business that he once built and old unpaid debt associated

with the prior business before his call up to active duty. As his bankruptcy counsel, ideally I would like to seek top repay his debt through a plan that would take us through one business cycle – lawn care is a seasonal business – and then make an informed decision on whether to seek bankruptcy relief. If the time period in H.R. 4044 is too short, then I will be forced to make the decision, usually erring in favor of bankruptcy relief – well before I have all the facts. I would recommend that the time period be extended by an additional one year so that you have the 6 months to expunge any service-connected influence on the calculation of Current Monthly Income and one year to seek to workout the debt in an informal, consensual manner.

4. Please explain the impact of a servicemember's filing for bankruptcy on his or her security clearance.

In response to your question, I have attached as Exhibit A the Adjudicative Guidelines for Determining Eligibility for Access to Classified Information, dated 29 December 2005. In that Exhibit, at Guideline F, one finds financial considerations assessed to determine whether to grant a security clearance, and if one has already been granted, to suspend or revoke such clearance. The reasons financial condition is considered are clearly articulated in the Guideline:

> 18. *The Concern.* Failure or inability to live within one's means, satisfy debts, and meet financial obligations may indicate poor self-control, lack of judgment, or unwillingness to abide by rules and regulations, all of which can raise questions about an individual's reliability, trustworthiness and ability to protect classified information. An individual who is financially overextended is at risk of having to engage in illegal acts to generate funds. Compulsive gambling is a concern as it may lead to financial crimes including espionage. Affluence that cannot be explained by known sources of income is also a security concern. It may indicate proceeds from financially profitable criminal acts.

Among the Guideline F considerations are:

> (a) inability or unwillingness to satisfy debts;
> (b) indebtedness caused by frivolous or irresponsible spending and the absence of any evidence of willingness or intent to pay the debt or establish a realistic plan to pay the debt.
> (c) a history of not meeting financial obligations;
> (d) deceptive or illegal financial practices such as embezzlement, employee theft, check fraud, income tax evasion, expense account fraud, filing deceptive loan statements, and other intentional financial breaches of trust;

(e) consistent spending beyond one's means, which may be indicated by excessive indebtedness, significant negative cash flow, high debt-to-income ratio, and/or other financial analysis;
(f) financial problems that are linked to drug abuse, alcoholism, gambling problems, or other issues of security concern.
(g) failure to file annual Federal, state, or local income tax returns as required or the fraudulent filing of the same;
(h) unexplained affluence, as shown by a lifestyle or standard of living, increase in net worth, or money transfers that cannot be explained by subject's known legal sources of income;
(i) compulsive or addictive gambling as indicated by an unsuccessful attempt to stop gambling, "chasing losses" (i.e. increasing the bets or returning another day in an effort to get even), concealment of gambling losses, borrowing money to fund gambling or pay gambling debts, family conflict or other problems caused by gambling.

Note that one attribute of financial distress is conspicuously missing – having commenced a bankruptcy case. Both a consideration of cases filed concerning revocation or denial of clearances and discussions with military advisors suggest that seeking bankruptcy relief is not a proper consideration justifying the denial or revocation of a security clearance. In fact, a good faith bankruptcy filing is a positive indication of willingly attempting to satisfy one's debts to the extent possible. However, a bad faith bankruptcy filing would suggest that one is not attempting to pay one's debts and could constitute grounds for denial or revocation of a security clearance. In summary, the commencement of a bankruptcy case by a servicemember in good faith will be viewed as a positive step in managing one's debts and should not be viewed, standing alone, as grounds for an adverse decision on one's security clearance.

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THE WHITE HOUSE
WASHINGTON

December 29, 2005

MEMORANDUM FOR WILLIAM LEONARD
Director
Information Security Oversight Office

SUBJECT: ADJUDICATIVE GUIDELINES

The President has approved the attached revision of the Adjudicative Guidelines for Determining Eligibility for Access to Classified Information as recommended unanimously by the NSC's PCC on Records Access and Information Security. Please circulate the revised guidelines to all affected agencies for immediate implementation. It is important to emphasize that all agencies must honor clearances granted under these guidelines, consistent with Executive Order 12968 and the December 12, 2005 memorandum to agencies from OMB Deputy Director for Management Clay Johnson.

Stephen J. Hadley
Assistant to the President for National Security Affairs

Attachment
Tab A
Revised Adjudicative Guidelines for Determining Eligibility for Access to Classified Information

ADJUDICATIVE GUIDELINES FOR DETERMINING ELIGIBILITY FOR ACCESS TO CLASSIFIED INFORMATION

1. *Introduction.* The following adjudicative guidelines are established for all U.S. government civilian and military personnel, consultants, contractors, employees of contractors, licensees, certificate holders or grantees and their employees and other

individuals who require access to classified information. They apply to persons being considered for initial or continued eligibility for access to classified information, to include sensitive compartmented information and special access programs, and are to be used by government departments and agencies in all final clearance determinations. Government departments and agencies may also choose to apply these guidelines to analogous situations regarding persons being considered for access to other types of protected information.

Decisions regarding eligibility for access to classified information take into account factors that could cause a conflict of interest and place a person in the position of having to choose between his or her commitment to the United States, including the commitment to protect classified information, and any other compelling loyalty. Access decisions also take into account a person's reliability, trustworthiness and ability to protect classified information. No coercive policing could replace the self-discipline and integrity of the person entrusted with the nation's secrets as the most effective means of protecting them. When a person's life history shows evidence of unreliability or untrustworthiness, questions arise whether the person can be relied on and trusted to exercise the responsibility necessary for working in a secure environment where protecting classified information is paramount.

2. *The Adjudicative Process.*

(a) The adjudicative process is an examination of a sufficient period of a person's life to make an affirmative determination that the person is an acceptable security risk. Eligibility for access to classified information is predicated upon the individual meeting these personnel security guidelines. The adjudication process is the careful weighing of a number of variables known as the whole-person concept. Available, reliable information about the person, past and present, favorable and unfavorable, should be considered in reaching a determination. In evaluating the relevance of an individual's conduct, the adjudicator should consider the following factors:

(1) The nature, extent, and seriousness of the conduct;

(2) the circumstances surrounding the conduct, to include knowledgeable participation;

(3) the frequency and recency of the conduct;

(4) the individual's age and maturity at the time of the conduct;

(5) the extent to which participation is voluntary;

(6) the presence or absence of rehabilitation and other permanent behavioral changes;

(7) the motivation for the conduct;

(8) the potential for pressure, coercion, exploitation, or duress; and

(9) the likelihood of continuation or recurrence.

(b) Each case must be judged on its own merits, and final determination remains the responsibility of the specific department or agency. Any doubt concerning personnel being considered for access to classified information will be resolved in favor of the national security.

(c) The ability to develop specific thresholds for action under these guidelines is limited by the nature and complexity of human behavior. The ultimate determination of whether the granting or continuing of eligibility for a security clearance is clearly consistent with the interests of national security must be an overall common sense judgment based upon careful consideration of the following guidelines, each of which is to be evaluated in the context of the whole person.

(1) GUIDELINE A: Allegiance to the United States;

(2) GUIDELINE B: Foreign Influence;

(3) GUIDELINE C: Foreign Preference;

(4) GUIDELINE D: Sexual Behavior;

(5) GUIDELINE E: Personal Conduct;

(6) GUIDELINE F: Financial Considerations;

(7) GUIDELINE G: Alcohol Consumption;

(8) GUIDELINE H: Drug Involvement;

(9) GUIDELINE I: Psychological Conditions;

(10) GUIDELINE J: Criminal Conduct;

(11) GUIDELINE K: Handling Protected Information;

(12) GUIDELINE L: Outside Activities;

(13) GUIDELINE M: Use of Information Technology Systems

(d) Although adverse information concerning a single criterion may not be sufficient for an unfavorable determination, the individual may be disqualified if available information reflects a recent or recurring pattern of questionable judgment, irresponsibility, or emotionally unstable behavior. Notwithstanding the whole-person concept, pursuit of further investigation may be terminated by an appropriate adjudicative agency in the face of reliable, significant, disqualifying, adverse information.

(e) When information of security concern becomes known about an individual who is currently eligible for access to classified information, the adjudicator should consider whether the person:

(1) voluntarily reported the information;
(2) was truthful and complete in responding to questions;
(3) sought assistance and followed professional guidance, where appropriate;
(4) resolved or appears likely to favorably resolve the security concern:
(5) has demonstrated positive changes in behavior and employment;
(6) should have his or her access temporarily suspended pending final adjudication of the information.

(f) If after evaluating information of security concern, the adjudicator decides that the information is not serious enough to warrant a recommendation of disapproval or revocation of the security clearance, it may be appropriate to recommend approval with a warning that future incidents of a similar nature may result in revocation of access.

GUIDELINE A: ALLEGIANCE TO THE UNITED STATES

3. *The Concern.* An individual must be of unquestioned allegiance to the United States. The willingness to safeguard classified information is in doubt if there is any reason to suspect an individual's allegiance to the United States.

4. *Conditions that could raise a security concern and may be disqualifying include:*

(a) involvement in, support of, training to commit, or advocacy of any act of sabotage, espionage, treason, terrorism, or sedition against the United States of America;

(b) association or sympathy with persons who are attempting to commit, or who are committing, any of the above acts;

(c) association or sympathy with persons or organizations that advocate, threaten, or use force or violence, or use any other illegal or unconstitutional means, in an effort to:

(1) overthrow or influence the government of the United States or any state or local government;

(2) prevent Federal, state, or local government personnel from performing their official duties;

(3) gain retribution for perceived wrongs caused by the Federal, state, or local government;

(4) prevent others from exercising their rights under the Constitution or laws of the United States or of any state.

5. *Conditions that could mitigate security concerns include:*

(a) the individual was unaware of the unlawful aims of the individual or organization and severed ties upon learning of these;

(b) the individual's involvement was only with the lawful or humanitarian aspects of such an organization;

(c) involvement in the above activities occurred for only a short period of time and was attributable to curiosity or academic interest;

(d) the involvement or association with such activities occurred under such unusual circumstances, or so much times has elapsed, that it is unlikely to recur and does not cast doubt on the individual's current reliability, trustworthiness, or loyalty.

GUIDELINE B: FOREIGN INFLUENCE

6. *The Concern.* Foreign contacts and interests may be a security concern if the individual has divided loyalties or foreign financial interests, may be manipulated or induced to help a foreign person, group, organization, or government in a way that is not in U.S. interests, or is vulnerable to pressure or coercioon by any foreign interest. Adjudication under this Guideline can and should consider the identity of the foreign country in which the foreign

contact or financial interest is located, including, but not limited to, such considerations as whether the foreign country is known to target United States citizens to obtain protected information and/or is associated with a risk of terrorism.

7. *Conditions that could raise a security concern and may be disqualifying include:*

(a) contact with a foreign family member, business or professional associate, friend, or other person who is a citizen of or resident in a foreign country if that contact creates a heightened risk of foreign exploitation, inducement, manipulation, pressure, or coercion;

(b) connections to a foreign person, group, government, or country that create a potential conflict of interest between the individual's obligation to protect sensitive information or technology and the individual's desire to help a foreign person, group, or country by providing that information;

(c) counterintelligence information, that may be classified, indicates that the individual's access to protected information may involve unacceptable risk to national security;

(d) sharing living quarters with a person or persons, regardless of citizenship status, if that relationship creates a heightened risk of foreign inducement, manipulation, pressure, or coercion;

(e) a substantial business, financial, or property interest in a foreign country, or in any foreign-owned or foreign-operated business, which could subject the individual to heightened risk of foreign influence or exploitation;

(f) failure to report, when required, association with a foreign national;

(g) unauthorized association with a suspected or known agent, associate, or employee of a foreign intelligence service;

(h) indications that representatives or nationals from a foreign country are acting to increase the vulnerability of the individual to possible future exploitation, inducement, manipulation, pressure, or coercion;

(i) conduct, especially while traveling outside the U.S., which may make the individual vulnerable to exploitation, pressure, or coercion by a foreign person, group, government, or country.

8. *Conditions that could mitigate security concerns include:*

(a) the nature of the relationships with foreign persons, the country in which these persons are located, or the positions or activities of those persons in that country are such that it is unlikely the individual will be placed in a position of having to choose between the interests of a foreign individual, group, organization, or government and the interests of the U.S.;

(b) there is no conflict of interest, either because the individual's sense of loyalty or obligation to the foreign person, group, government, or country is so minimal, or the individual has such deep and longstanding relationships and loyalties in the U. S., that the individual can be expected to resolve any conflict of interest in favor of the U.S. interest;

(c) contact or communication with foreign citizens is so casual and infrequent that there is little likelihood that it could create a risk for foreign influence or exploitation;

(d) the foreign contacts and activities are on U.S. Government business or are approved by the cognizant security authority;

(e) the individual has promptly complied with existing agency requirements regarding the reporting of contacts, requests, or threats from persons, groups, or organizations from a foreign country;

(f) the value or routine nature of the foreign business, financial, or property interests is such that they are unlikely to result in a conflict and could not be used effectively to influence, manipulate, or pressure the individual.

GUIDELINE C: FOREIGN PREFERENCE

9. *The Concern.* When an individual acts in such a way as to indicate a preference for a foreign country over the United States, then he or she may be prone to provide information or make decisions that are harmful to the interests of the United States.

10. *Conditions that could raise a security concern and may be disqualifying include:*

(a) exercise of any right, privilege or obligation of foreign citizenship after becoming a U.S. citizen or through the foreign citizenship of a family member. This includes but is not limited to:

(1) possession of a current foreign passport;

(2) military service or a willingness to bear arms for a foreign country;

(3) accepting educational, medical, retirement, social welfare, or other such benefits from a foreign country;

(4) residence in a foreign country to meet citizenship requirements;

(5) using foreign citizenship to protect financial or business interests in another country;

(6) seeking or holding political office in a foreign country;

(7) voting in a foreign election;

(b) action to acquire or obtain recognition of a foreign citizenship by an American citizen;

(c) performing or attempting to perform duties, or otherwise acting, so as to serve the interests of a foreign person, group, organization, or government in conflict with the national security interest;

(d) any statement or action that shows allegiance to a country other than the United States: for example, declaration of intent to renounce United States citizenship; renunciation of United States citizenship.

11. *Conditions that could mitigate security concerns include:*

(a) dual citizenship is based solely on parents' citizenship or birth in a foreign country;

(b) the individual has expressed a willingness to renounce dual citizenship;

(c) exercise of the rights, privileges, or obligations of foreign citizenship occurred before the individual became a U.S. citizen or when the individual was a minor;

(d) use of a foreign passport is approved by the cognizant security authority;

(e) the passport has been destroyed, surrendered to the cognizant security authority, or otherwise invalidated;

(f) the vote in a foreign election was encouraged by the United States Government.

GUIDELINE D: SEXUAL BEHAVIOR

12. *The Concern.* Sexual behavior that involves a criminal offense, indicates a personality or emotional disorder, reflects lack of judgment or discretion, or which may subject the individual to undue influence or coercion, exploitation, or duress can raise questions about an individual's reliability, trustworthiness and ability to protect classified information. No adverse inference concerning the standards in the Guideline may be raised solely on the basis of the sexual orientation of the individual.

13. *Conditions that could raise a security concern and may be disqualifying include:*

(a) sexual behavior of a criminal nature, whether or not the individual has been prosecuted;

(b) a pattern of compulsive, self-destructive, or high-risk sexual behavior that the person is unable to stop or that may be symptomatic of a personality disorder;

(c) sexual behavior that causes an individual to be vulnerable to coercion, exploitation, or duress;

(d) sexual behavior of a public nature and/or that which reflects lack of discretion or judgment.

14. *Conditions that could mitigate security concerns include:*

(a) the behavior occurred prior to or during adolescence and there is no evidence of subsequent conduct of a similar nature;

(b) the sexual behavior happened so long ago, so infrequently, or under such unusual circumstances, that it is unlikely to recur and does not cast doubt on the individual's current reliability, trustworthiness, or good judgment;

(c) the behavior no longer serves as a basis for coercion, exploitation, or duress;

(d) the sexual behavior is strictly private, consensual, and discreet.

GUIDELINE E: PERSONAL CONDUCT

15. *The Concern.* Conduct involving questionable judgment, lack of candor, dishonesty, or unwillingness to comply with rules and regulations can raise questions about an

individual's reliability, trustworthiness and ability to protect classified information. Of special interest is any failure to provide truthful and candid answers during the security clearance process or any other failure to cooperate with the security clearance process.

The following will normally result in an unfavorable clearance action or administrative termination of further processing for clearance eligibility:

(a) refusal, or failure without reasonable cause, to undergo or cooperate with security processing, including but not limited to meeting with a security investigator for subject interview, completing security forms or releases, and cooperation with medical or psychological evaluation;

(b) refusal to provide full, frank and truthful answers to lawful questions of investigators, security officials, or other official representatives in connection with a personnel security or trustworthiness determination.

16. *Conditions that could raise a security concern and may be disqualifying also include:*

(a) deliberate omission, concealment, or falsification of relevant facts from any personnel security questionnaire, personal history statement, or similar form used to conduct investigations, determine employment qualifications, award benefits or status, determine security clearance eligibility or trustworthiness, or award fiduciary responsibilities;

(b) deliberately providing false or misleading information concerning relevant facts to an employer, investigator, security official, competent medical authority, or other official government representative;

(c) credible adverse information in several adjudicative issue areas that is not sufficient for an adverse determination under any other single guideline, but which, when considered as a whole, supports a whole-person assessment of questionable judgment, untrustworthiness, unreliability, lack of candor, unwillingness to comply with rules and regulations, or other characteristics indicating that the person may not properly safeguard protected information;

(d) credible adverse information that is not explicitly covered under any other guideline and may not be sufficient by itself for an adverse determination, but which, when combined with all available information supports a whole-person assessment of questionable judgment, untrustworthiness, unreliability, lack of candor, unwillingness to comply with rules and regulations, or other characteristics indicating that the person may not properly safeguard protected information. This includes but is not limited to consideration of:

(1) untrustworthy or unreliable behavior to include breach of client confidentiality, release of proprietary information, unauthorized release of sensitive corporate or other government protected information;

(2) disruptive, violent, or other inappropriate behavior in the workplace;

(3) a pattern of dishonesty or rule violations;

(4) evidence of significant misuse of Government or other employer's time or resources;

(e) personal conduct or concealment of information about one's conduct, that creates a vulnerability to exploitation, manipulation, or duress, such as (1) engaging in activities which, if known, may affect the person's personal, professional, or community standing, or (2) while in another country, engaging in any activity that is illegal in that country or that is legal in that country but illegal in the United States and may serve as a basis for exploitation or pressure by the foreign security or intelligence service or other group;

(f) violation of a written or recorded commitment made by the individual to the employer as a condition of employment;

(g) association with persons involved in criminal activity.

17. *Conditions that could mitigate security concerns include:*

(a) the individual made prompt, good-faith efforts to correct the omission, concealment, or falsification before being confronted with the facts;

(b) the refusal or failure to cooperate, omission, or concealment was caused or significantly contributed to by improper or inadequate advice of authorized personnel or legal counsel advising or instructing the individual specifically concerning the security clearance process. Upon being made aware of the requirement to cooperate or provide the information, the individual cooperated fully and truthfully;

(c) the offense is so minor, or so much time has passed, or the behavior is so infrequent, or it happened under such unique circumstances that it is unlikely to recur and does not cast doubt on the individual's reliability, trustworthiness, or good judgment;

(d) the individual has acknowledged the behavior and obtained counseling to change the behavior or taken other positive steps to alleviate the stressors, circumstances, or factors that caused untrustworthy, unreliable, or other inappropriate behavior, and such behavior is unlikely to recur;

(e) the individual has taken positive steps to reduce or eliminate vulnerability to exploitation, manipulation, or duress;

(f) association with persons involved in criminal activities has ceased or occurs under circumstances that do not cast doubt upon the individual's reliability, trustworthiness, judgment, or willingness to comply with rules and regulations.

GUIDELINE F: FINANCIAL CONSIDERATIONS

18. *The Concern.* Failure or inability to live within one's means, satisfy debts, and meet financial obligations may indicate poor self-control, lack of judgment, or unwillingness to abide by rules and regulations, all of which can raise questions about an individual's reliability, trustworthiness and ability to protect classified information. An individual who is financially overextended is at risk of having to engage in illegal acts to generate funds. Compulsive gambling is a concern as it may lead to financial crimes including espionage. Affluence that cannot be explained by known sources of income is also a security concern. It may indicate proceeds from financially profitable criminal acts.

19. *Conditions that could raise a security concern and may be disqualifying include:*

(a) inability or unwillingness to satisfy debts;

(b) indebtedness caused by frivolous or irresponsible spending and the absence of any evidence of willingness or intent to pay the debt or establish a realistic plan to pay the debt.

(c) a history of not meeting financial obligations;

(d) deceptive or illegal financial practices such as embezzlement, employee theft, check fraud, income tax evasion, expense account fraud, filing deceptive loan statements, and other intentional financial breaches of trust;

(e) consistent spending beyond one's means, which may be indicated by excessive indebtedness, significant negative cash flow, high debt-to-income ratio, and/or other financial analysis;

(f) financial problems that are linked to drug abuse, alcoholism, gambling

problems, or other issues of security concern.

(g) failure to file annual Federal, state, or local income tax returns as required or the fraudulent filing of the same;

(h) unexplained affluence, as shown by a lifestyle or standard of living, increase in net worth, or money transfers that cannot be explained by subject's known legal sources of income;

(i) compulsive or addictive gambling as indicated by an unsuccessful attempt to stop gambling, "chasing losses" (i.e. increasing the bets or returning another day in an effort to get even), concealment of gambling losses, borrowing money to fund gambling or pay gambling debts, family conflict or other problems caused by gambling.

20. *Conditions that could mitigate security concerns include:*

(a) the behavior happened so long ago, was so infrequent, or occurred under such circumstances that it is unlikely to recur and does not cast doubt on the individual's current reliability, trustworthiness, or good judgment;

(b) the conditions that resulted in the financial problem were largely beyond the person's control (e.g. loss of employment, a business downturn, unexpected medical emergency, or a death, divorce or separation), and the individual acted responsibly under the circumstances;

(c) the person has received or is receiving counseling for the problem and/or there are clear indications that the problem is being resolved or is under control;

(d) the individual initiated a good-faith effort to repay overdue creditors or otherwise resolve debts;

(e) the individual has a reasonable basis to dispute the legitimacy of the past-due debt which is the cause of the problem and provides documented proof to substantiate the basis of the dispute or provides evidence of actions to resolve the issue;

(f) the affluence resulted from a legal source of income.

GUIDELINE G: ALCOHOL CONSUMPTION

21. *The Concern.* Excessive alcohol consumption often leads to the exercise of questionable judgment or the failure to control impulses, and can raise questions about an individual's reliability and trustworthiness.

22. *Conditions that could raise a security concern and may be disqualifying include:*

(a) alcohol-related incidents away from work, such as driving while under the influence, fighting, child or spouse abuse, disturbing the peace, or other incidents of concern, regardless of whether the individual is diagnosed as an alcohol abuser or alcohol dependent;

(b) alcohol-related incidents at work, such as reporting for work or duty in an intoxicated or impaired condition, or drinking on the job, regardless of whether the individual is diagnosed as an alcohol abuser or alcohol dependent;

(c) habitual or binge consumption of alcohol to the point of impaired judgment, regardless of whether the individual is diagnosed as an alcohol abuser or alcohol dependent;

(d) diagnosis by a duly qualified medical professional (e.g., physician, clinical psychologist, or psychiatrist) of alcohol abuse or alcohol dependence;

(e) evaluation of alcohol abuse or alcohol dependence by a licensed clinical social worker who is a staff member of a recognized alcohol treatment program;

(f) relapse after diagnosis of alcohol abuse or dependence and completion of an alcohol rehabilitation program;

(g) failure to follow any court order regarding alcohol education, evaluation, treatment, or abstinence.

23. *Conditions that could mitigate security concerns include*:

(a) so much time has passed, or the behavior was so infrequent, or it happened under such unusual circumstances that it is unlikely to recur or does not cast doubt on the individual's current reliability, trustworthiness, or good judgment;

(b) the individual acknowledges his or her alcoholism or issues of alcohol abuse, provides evidence of actions taken to overcome this problem, and has established a pattern of abstinence (if alcohol dependent) or responsible use (if an alcohol abuser);

(c) the individual is a current employee who is participating in a counseling or treatment program, has no history of previous treatment and relapse, and is making satisfactory progress;

(d) the individual has successfully completed inpatient or outpatient counseling or rehabilitation along with any required aftercare, has demonstrated a clear and established pattern of modified consumption or abstinence in accordance with treatment recommendations, such as participation in meetings of Alcoholics Anonymous or a similar organization and has received a favorable prognosis by a duly qualified medical professional or a licensed clinical social worker who is a staff member of a recognized alcohol treatment program.

GUIDELINE H: DRUG INVOLVEMENT

24. *The Concern.* Use of an illegal drug or misuse of a prescription drug can raise questions about an individual's reliability and trustworthiness, both because it may impair judgment and because it raises questions about a person's ability or willingness to comply with laws, rules, and regulations.

(a) Drugs are defined as mood and behavior altering substances, and include:

(1) Drugs, materials, and other chemical compounds identified and listed in the Controlled Substances Act of 1970, as amended (e.g., marijuana or cannabis, depressants, narcotics, stimulants, and hallucinogens), and (2) inhalants and other similar substances;

(b) drug abuse is the illegal use of a drug or use of a legal drug in a manner that deviates from approved medical direction.

25. *Conditions that could raise a security concern and may be disqualifying include:*

(a) Any drug abuse (see above definition);

(b) testing positive for illegal drug use;

(c) illegal drug possession, including cultivation, processing, manufacture, purchase, sale, or distribution; or possession of drug paraphernalia;

(d) diagnosis by a duly qualified medical professional (e.g., physician, clinical psychologist, or psychiatrist) of drug abuse or drug dependence;

(e) evaluation of drug abuse or drug dependence by a licensed clinical social worker who is a staff member of a recognized drug treatment program;

(f) failure to successfully complete a drug treatment program prescribed by a duly qualified medical professional;

(g) any illegal drug use after being granted a security clearance;

(h) expressed intent to continue illegal drug use, or failure to clearly and convincingly commit to discontinue drug use.

26. *Conditions that could mitigate security concerns include:*

(a) the behavior happened so long ago, was so infrequent, or happened under such circumstances that it is unlikely to recur or does not cast doubt on the individual's current reliability, trustworthiness, or good judgment;

(b) a demonstrated intent not to abuse any drugs in the future, such as:

(1) dissociation from drug-using associates and contacts;

(2) changing or avoiding the environment where drugs were used;

(3) an appropriate period of abstinence;

(4) a signed statement of intent with automatic revocation of clearance for any violation;

(c) abuse of prescription drugs was after a severe or prolonged illness during which these drugs were prescribed, and abuse has since ended;

(d) satisfactory completion of a prescribed drug treatment program, including but not limited to rehabilitation and aftercare requirements, without recurrence of abuse, and a favorable prognosis by a duly qualified medical professional.

GUIDELINE I: PSYCHOLOGICAL CONDITIONS

27. *The Concern.* Certain emotional, mental, and personality conditions can impair judgment, reliability, or trustworthiness. A formal diagnosis of a disorder is not required for there to be a concern under this guideline. A duly qualified mental health professional (e.g., clinical psychologist or psychiatrist) employed by, or acceptable to and approved by

the U.S. Government, should be consulted when evaluating potentially disqualifying and mitigating information under this guideline. No negative inference concerning the standards in this Guideline may be raised solely on the basis of seeking mental health counseling.

28. *Conditions that could raise a security concern and may be disqualifying include:*

(a) behavior that casts doubt on an individual's judgment, reliability, or trustworthiness that is not covered under any other guideline, including but not limited to emotionally unstable, irresponsible, dysfunctional, violent, paranoid, or bizarre behavior;

(b) an opinion by a duly qualified mental health professional that the individual has a condition not covered under any other guideline that may impair judgment, reliability, or trustworthiness;

(c) the individual has failed to follow treatment advice related to a diagnosed emotional, mental, or personality condition, e.g. failure to take prescribed medication.

29. *Conditions that could mitigate security concerns include:*

(a) the identified condition is readily controllable with treatment, and the individual has demonstrated ongoing and consistent compliance with the treatment plan;

(b) the individual has voluntarily entered a counseling or treatment program for a condition that is amenable to treatment, and the individual is currently receiving counseling or treatment with a favorable prognosis by a duly qualified mental health professional;

(c) recent opinion by a duly qualified mental health professional employed by, or acceptable to and approved by the U.S. Government that an individual's previous condition is under control or in remission, and has a low probability of recurrence or exacerbation;

(d) the past emotional instability was a temporary condition (e.g., one caused by a death, illness, or marital breakup), the situation has been resolved, and the individual no longer shows indications of emotional instability;

(e) there is no indication of a current problem.

GUIDELINE J: CRIMINAL CONDUCT

30. *The Concern.* Criminal activity creates doubt about a person's judgment, reliability and trustworthiness. By its very nature, it calls into question a person's ability or willingness to comply with laws, rules and regulations.

31. *Conditions that could raise a security concern and may be disqualifying include:*

(a) a single serious crime or multiple lesser offenses;

(b) discharge or dismissal from the Armed Forces under dishonorable conditions;

(c) allegation or admission of criminal conduct, regardless of whether the person was formally charged, formally prosecuted or convicted;

(d) individual is currently on parole or probation;

(e) violation of parole or probation, or failure to complete a court-mandated rehabilitation program.

32. *Conditions that could mitigate security concerns include:*

(a) so much time has elapsed since the criminal behavior happened, or it happened under such unusual circumstances that it is unlikely to recur or does not cast doubt on the individual's reliability, trustworthiness, or good judgment;

(b) the person was pressured or coerced into committing the act and those pressures are no longer present in the person's life;

(c) evidence that the person did not commit the offense;

(d) there is evidence of successful rehabilitation; including but not limited to the passage of time without recurrence of criminal activity, remorse or restitution, job training or higher education, good employment record, or constructive community involvement.

GUIDELINE K: HANDLING PROTECTED INFORMATION

33. *The Concern.* Deliberate or negligent failure to comply with rules and regulations for protecting classified or other sensitive information raises doubt about an individual's trustworthiness, judgment, reliability, or willingness and ability to safeguard such information, and is a serious security concern.

34. *Conditions that could raise a security concern and may be disqualifying include:*

(a) deliberate or negligent disclosure of classified or other protected information to unauthorized persons, including but not limited to personal or business contacts, to the media, or to persons present at seminars, meetings, or conferences;

(b) collecting or storing classified or other protected information in any unauthorized location;

(c) loading, drafting, editing, modifying, storing, transmitting, or otherwise handling classified reports, data, or other information on any unapproved equipment including but not limited to any typewriter, word processor, or computer hardware, software, drive, system, gameboard, handheld, "palm" or pocket device or other adjunct equipment;

(d) inappropriate efforts to obtain or view classified or other protected information outside one's need to know;

(e) copying classified or other protected information in a manner designed to conceal or remove classification or other document control markings;

(f) viewing or downloading information from a secure system when the information is beyond the individual's need to know;

(g) any failure to comply with rules for the protection of classified or other sensitive information;

(h) negligence or lax security habits that persist despite counseling by management;

(i) failure to comply with rules or regulations that results in damage to the National Security, regardless of whether it was deliberate or negligent.

35. *Conditions that could mitigate security concerns include:*

(a) so much time has elapsed since the behavior, or it happened so infrequently or under such unusual circumstances that it is unlikely to recur or does not cast doubt on the individual's current reliability, trustworthiness, or good judgment;

(b) the individual responded favorably to counseling or remedial security training and now demonstrates a positive attitude toward the discharge of security

responsibilities;

(c) the security violations were due to improper or inadequate training.

GUIDELINE L: OUTSIDE ACTIVITIES

36. *The Concern.* Involvement in certain types of outside employment or activities is of security concern if it poses a conflict of interest with an individual's security responsibilities and could create an increased risk of unauthorized disclosure of classified information.

37. *Conditions that could raise a security concern and may be disqualifying include:*

(a) any employment or service, whether compensated or volunteer, with:

(1) the government of a foreign country;

(2) any foreign national, organization, or other entity;

(3) a representative of any foreign interest;

(4) any foreign, domestic, or international organization or person engaged in analysis, discussion, or publication of material on intelligence, defense, foreign affairs, or protected technology;

(b) failure to report or fully disclose an outside activity when this is required.

38. *Conditions that could mitigate security concerns include:*

(a) evaluation of the outside employment or activity by the appropriate security or counterintelligence office indicates that it does not pose a conflict with an individual's security responsibilities or with the national security interests of the United States;

(b) the individual terminates the employment or discontinued the activity upon being notified that it was in conflict with his or her security responsibilities.

GUIDELINE M: USE OF INFORMATION TECHNOLOGY SYSTEMS

39. *The Concern.* Noncompliance with rules, procedures, guidelines or regulations pertaining to information technology systems may raise security concerns about an

individual's reliability and trustworthiness, calling into question the willingness or ability to properly protect sensitive systems, networks, and information. Information Technology Systems include all related computer hardware, software, firmware, and data used for the communication, transmission, processing, manipulation, storage, or protection of information.

40. *Conditions that could raise a security concern and may be disqualifying include:*

(a) illegal or unauthorized entry into any information technology system or component thereof;

(b) illegal or unauthorized modification, destruction, manipulation or denial of access to information, software, firmware, or hardware in an information technology system;

(c) use of any information technology system to gain unauthorized access to another system or to a compartmented area within the same system;

(d) downloading, storing, or transmitting classified information on or to any unauthorized software, hardware, or information technology system;

(e) unauthorized use of a government or other information technology system;

(f) introduction, removal, or duplication of hardware, firmware, software, or media to or from any information technology system without authorization, when prohibited by rules, procedures, guidelines or regulations.

(g) negligence or lax security habits in handling information technology that persist despite counseling by management;

(h) any misuse of information technology, whether deliberate or negligent, that results in damage to the national security.

41. *Conditions that could mitigate security concerns include:*

(a) so much time has elapsed since the behavior happened, or it happened under such unusual circumstances, that it is unlikely to recur or does not cast doubt on the individual's reliability, trustworthiness, or good judgment;

(b) the misuse was minor and done only in the interest of organizational efficiency and effectiveness, such as letting another person use one's password or computer when no other timely alternative was readily available;

(c) the conduct was unintentional or inadvertent and was followed by a prompt, good-faith effort to correct the situation and by notification of supervisor.

**Questions for the Record by Ranking Member Chris Cannon,
Subcommittee on Commercial and Administrative Law,
"Hearing on H.R. 4044," Tuesday, April 1, 2008, 2:00 p.m., 2141 Rayburn**

Questions for Professor Jack F. Williams, American Bankruptcy Institute (Republican-called witness):

Ranking Member Cannon, thank you for the opportunity to respond further to additional questions you have submitted on behalf of the Subcommittee. Below are my answers to your specific questions. If you have any additional questions or comments, please do not hesitate to contact me.

1. What is the typical financial scenario that causes a reservist or guardsman to veer towards bankruptcy? What could Congress do proactively to keep that scenario from producing bankruptcies to begin with?

In my experience as both an academic and practitioner, I would suggest five typical scenarios that may cause an activated reservist/guardsmen servicemember to seek bankruptcy relief. My experience leads me to believe that the most common scenarios are found in Situations 1 and 2, followed closely by Situation 3. However, I caution that this is a personal observation in consultation with several other practitioners and judges; it is not an observation bases on a careful empirical analysis.

1. *Small businessman who lost his customer base once activated:* This individual may be the most sympathetic of the lot. Typically, he started a business, usually a sole proprietorship, and has grown it into a reasonably successful small operation. Once activated, however, he will lose his client base and may not be able to pay existing business debt that he also owes in his personal capacity. Once he returns to civilian life, he must restart the business, incur additional debt, seek to repay old debt, feed and provide shelter for his family, and grow his customer base once again. All this involves additional risk caused by an extended activation that may result in the commencement of a bankruptcy case.
2. *Reduction in income because of activation:* This individual, upon activation, leaves a higher-paying job for a lower salaried job in military service. However, his fixed expenses, like a home mortgage, credit card debt, children's educational expenses, and the like, remain a function of his prior pre-activation income levels. The inability to secure comparable income while in military service causes or exacerbates financial difficulty culminating in a bankruptcy filing.
3. *Increase in pay because of activation corresponding to an increase in access to credit and debt:* This individual (and his spouse) has incurred additional debt while on active duty at a level that he may reasonably expect to repay at his increased military pay. According to a RAND study, 83% of all activated reservists experience an increase in pay. This may be a result of a higher base pay, combat pay, and certain exemptions from federal income tax obligations.

The activation coupled with the de-activation results in an exacerbation of financial distress. Moreover, the enhanced military pay distorts the debtor's Current Monthly Income as presently calculated under the means test.

4. *Difficulty readjusting to civilian life For example, Post Traumatic Stress Disorder (PTSD):* There is growing empirical evidence that as many as one in five servicemembers returning from Operation Iraqi Freedom (OIF) and Operation Enduring Freedom(OEF) are experiencing difficulty in re-adjusting to civilian life. In many instances, separation from active duty is exceptionally quick and complete. These individuals may experience a plethora of problems, including financial distress.
5. *Personal irresponsibility:* It is not uncommon to find that activated and recently de-activated guardsmen and reservists incur debt in an irresponsible fashion. For example, some recently de-activated guardsmen and reservists have purchased expensive automobiles or undertake vacations well-beyond their means.

While not a complete solution, including a course on financial literacy that teaches a basic understanding of debt and budgeting, such as the one developed by the Boy Scouts of America, in basic training may assist the servicemember avoid some of the financial pitfalls. However, short of increasing military pay across the board and protecting activated guardsmen and reservists from abuse and discrimination in a more robust manner, there is little Congress can do to prevent these scenarios. Situations 1 – 3 are theoretically reasonably foreseeable by the individual who enters into military service as a guardsmen or reservist, although the duty extensions we have witnessed in OEF and OIF are relatively unprecedented in our recent history. I do outline several steps that Congress may want to consider in developing a more robust approach to the issue of excessive military debt and the concomitant financial distress.

2. **Reservists' and guardsmen's problem with the means test appears to be that the means test counts their pre-service, civilian pay in calculating their pre-bankruptcy, average income. Because of that, the means test can over-estimate their ability to pay their debt. If the problem is the way the means test calculates historical income, couldn't we consider amending the means test for reservists and guardsmen so that the court takes into account a more accurate assessment of a reservist's or guardsman's actual income stream, rather than exempt reservists and guardsmen from the means test outright?**

Initially, my reading of H.R.. 4044 does not support your characterization that the targeted provision constitutes an exemption from the means test. I would suggest that the title of the bill itself is misleading. H.R. 4044 contains an exemption from the application of the present rebuttable presumption of abuse if the means test is satisfied. If the servicemember has the means to repay a substantial portion of his debt, either the United States Trustee or the Bankruptcy Court may seek a determination of abuse under the totality of the circumstances. Present documentation required to be filed by the servicemember with his petition followed up by a thorough examination of the servicemember within 20 to 40 days from the commencement of the bankruptcy case at

the Section 341 meeting should provide all the information needed for the U.S. Trustee or the Bankruptcy Court to make a meaningful decision on whether the servicemember is abusing the bankruptcy process.

With that said, I am sympathetic to this line of thought; however, there is no clean way in which to achieve your goal without a complete re-write of the calculation of current monthly income (CMI) under the means test and a substantial revision of present forms filed with the bankruptcy court. Moreover, a change of the calculation of CMI exposes the means testing process to criticism that in many cases, well beyond the present limited universe of potential beneficiaries, CMI is not an accurate reflection of current monthly income, especially in a sluggish or contracting economy. Furthermore, the proposed change in CMI would actually increase the cost and complexity of seeking relief for servicemembers, a result that I believe is inconsistent with the view of all members of the Subcommittee.

3. **Won't the servicemen exempted by the legislation already qualify for relief under the means test's "special circumstances" provision? Why isn't that provision already adequate to the task?**

Possibly, but only after a hearing. Of course, that is the rub. A major theme of the 2005 Amendments, which included the means test in Section 707, was to limit bankruptcy judge's discretion. The prevailing thought is that bankruptcy judges could not be trusted to carry out the intent of Congress. Now relying on the special circumstances test as a means to address a pressing problem thrusts discretion back into a process that once sought to severely limit it. Moreover, the present system will require a servicemember to request a hearing on whether "special circumstances" warrant a departure from the presumption of abuse. That will require additional time and expense. For example, most attorneys I have spoken to on the subject would expect to undertake a minimum of about 20 hours of preparation and actual hearing time. At an average of about $250 an hour, that would amount to approximately $5,000 in additional expense incurred by a debtor already strapped for funds. Moreover, the debtor may be required to obtain an authorized leave or absence from military duty to attend. In some instances, courts have held telephonic hearings to accommodate servicemembers stationed overseas. Finally, a standard-like approach to this issue that relies on the development of a full evidentiary record to demonstrate "special circumstances" provides a great amount of uncertainty for both the servicemember and his counsel. That uncertainty poses increased risk that may be reflected in the price points used by counsel to set the initial fee.

4. **BAPCPA contained an exception from the means test for disabled veterans, but limited it to debts incurred primarily during periods of active service. If we are going to consider an exception for reservists and guardsmen, does the disabled veteran's exemption offer another model that we should explore? If so, should it be adapted to focus on indebtedness incurred primarily before periods of active service and/or on the impact of active service on a reservist's or guardsman's income stream or ability to ward off unexpected debt or financial crises?**

Again, I am sympathetic to the line of reasoning reflected in this question. However, the evident complexity of the question itself, its many subparts, and its contingencies suggest a coming complexity that may perplex courts and attorneys alike. In drafting any provision to help sympathetic servicemembers we must remember that first we should do no additional harm. Any solution we reach must be practical, workable, and should not unnecessarily increase the cost of bankruptcy borne by worthy servicemembers. Several colleagues and I have attempted, over the course of several days, to write a provision that accomplishes all that you seek in this question. Humbly, I must say that we have been unsuccessful without substantially increasing court discretion, uncertainly, and cost. Moreover, the disabled servicemember exemption was designed to address one compelling situation – service-connected disability coupled with debt incurred primarily while the servicemember was on active duty. That approach would not help, for example, the sole proprietor servicemember described in Situation 1, the servicemember who sees his pay dramatically cut as in Situation 2, or the servicemember having difficulty adjusting to civilian life as in Situation 4.

5. In your written statement, you cite an ongoing explosion in the number of servicemen losing their security clearances to debt issues. Isn't making bankruptcy more attractive likely to make that trend even worse?

No. For any professional, including a professional soldier, sailor, marine, airman, or Coast Guardsman, bankruptcy is never an attractive alternative. Necessary, yes; attractive, not in my experience. In response to your question, I have attached as Exhibit A the Adjudicative Guidelines for Determining Eligibility for Access to Classified Information, dated 29 December 2005. In that Exhibit, at Guideline F, one finds financial considerations assessed to determine whether to grant a security clearance, and if one has already been granted, to suspend or revoke such clearance. The reasons financial condition is considered are clearly articulated in the Guideline:

> 18. *The Concern.* Failure or inability to live within one's means, satisfy debts, and meet financial obligations may indicate poor self-control, lack of judgment, or unwillingness to abide by rules and regulations, all of which can raise questions about an individual's reliability, trustworthiness and ability to protect classified information. An individual who is financially overextended is at risk of having to engage in illegal acts to generate funds. Compulsive gambling is a concern as it may lead to financial crimes including espionage. Affluence that cannot be explained by known sources of income is also a security concern. It may indicate proceeds from financially profitable criminal acts.

Among the Guideline F considerations are:

> (a) inability or unwillingness to satisfy debts;

(b) indebtedness caused by frivolous or irresponsible spending and the absence of any evidence of willingness or intent to pay the debt or establish a realistic plan to pay the debt.
(c) a history of not meeting financial obligations;
(d) deceptive or illegal financial practices such as embezzlement, employee theft, check fraud, income tax evasion, expense account fraud, filing deceptive loan statements, and other intentional financial breaches of trust;
(e) consistent spending beyond one's means, which may be indicated by excessive indebtedness, significant negative cash flow, high debt-to-income ratio, and/or other financial analysis;
(f) financial problems that are linked to drug abuse, alcoholism, gambling problems, or other issues of security concern.
(g) failure to file annual Federal, state, or local income tax returns as required or the fraudulent filing of the same;
(h) unexplained affluence, as shown by a lifestyle or standard of living, increase in net worth, or money transfers that cannot be explained by subject's known legal sources of income;
(i) compulsive or addictive gambling as indicated by an unsuccessful attempt to stop gambling, "chasing losses" (i.e. increasing the bets or returning another day in an effort to get even), concealment of gambling losses, borrowing money to fund gambling or pay gambling debts, family conflict or other problems caused by gambling.

Note that one attribute of financial distress is conspicuously missing – having commenced a bankruptcy case. Both a consideration of cases filed concerning revocation or denial of clearances and discussions with military advisors suggest that seeking bankruptcy relief is not a proper consideration justifying the denial or revocation of a security clearance. In fact, a good faith bankruptcy filing is a positive indication of willingly attempting to satisfy one's debts to the extent possible. However, a bad faith bankruptcy filing would suggest that one is not attempting to pay one's debts and could constitute grounds for denial or revocation of a security clearance. In summary, the commencement of a bankruptcy case by a servicemember in good faith will be viewed as a positive step in managing one's debts and should not be viewed, standing alone, as grounds for an adverse decision on one's security clearance.

6. **How can we address these debt issues outside of bankruptcy? If we help reservists and guardsmen stay out of bankruptcy, won't that help both them and our military effectiveness (e.g., by safeguarding security clearances and reducing servicemen's financial distractions)?**

Yes, I strongly endorse a more robust approach to addressing financial distress experienced by military personnel, including reservists and guardsmen. Congress has already begun the process with positive steps toward relief. For example, Congress has enacted legislation to cap interest rates on so-called "payday" loans and has amended the

Servicemembers Civil Relief Act (SCRA) to, among other things, cap the interest rate on pre-service indebtedness at 6% and stay foreclosures and other administrative and judicial hearings for a certain period of time. I have also been impressed by the private efforts of a number of institutional lenders and financial institutions to work with servicemembers to address financial distress. I would suggest that more funding be authorized to support personal financial education of military personnel, their spouses, and their dependents. Further, as mentioned above, including this type of education in basic training should be considered. I am impressed by the awareness of the DoD of the problem of financial distress and many of the steps the DoD has undertaken to address the issues. However, DoD has not allocated the proper funding to support a widespread and robust program of prevention, education, and counseling and has inadequate resources in place to aid aggressively those military personnel at the early stages of financial distress.

7. **Do you agree that bankruptcy is a tool of last resort? If so, what other ways should we consider to address the financial pressures on a reservist or guardsman reporting for what might be extended duty?**

Yes. I strongly agree that bankruptcy is a tool of last resort. For example, I endorse an extension of the time period in H.R. 4044 from 6 months to 18 months because I want to see legislation that does not prematurely force a servicemember to seek bankruptcy relief until it is necessary. To me, a promise to repay one's debts is not only a legal duty, but also a moral obligation. Bankruptcy is a world of regret; no one really wants to be in that venue. Congress should consider the causes of financial failure and insist that proper empirical evidence be gathered so that it may make a more informed decision on how substantial the problem is, ways in which the problems may be addressed, and the like. Congress may also want to consider a program of special micro-loans and grants to returning servicemembers who left small businesses (Situation 1 above), low-interest bridge loans and more expanded protections in the SCRA for those servicemembers in Situation 2 above, preventive educational programming for servicemembers in Situation 3 above, and extended emotional and mental care for those in Situation 4 above transitioning from active duty to civilian live after an extended tour of duty.

8. **This bill would add additional credit risk for the lender asked to offer credit to a reservist or guardsman. Won't that raise the cost of credit for these servicemen? Won't that hurt them?**

I disagree that H.R. 4044 will add additional risk that would actually increase the cost of credit for reservists or guardsmen. This is a claim easily made and hard to prove. As reflected in my testimony and my response to the Questions presented by the Chair of the Subcommittee, in my opinion less than 2,500 potential debtors will be affected by this bill. The bankruptcy risk stays the same; the question is who should shoulder the cost of potential abuse. Even if you use the number that as many as 10% of pre-2005 debtors abused the system, that would still leave about 250 potential abusers. Many of those should be ferreted out by an attentive U.S. Trustee office and a more-motivated judiciary

directed by Congress to get really serious about debtor abuse. Moreover, Congress has already weighed the possibility of increased credit risk when it passed robust changes to the SCRA and moved dramatically in favor of greater servicemember protection. The result should be no different here.

9. The means test was critical to BAPCPA's consumer bankruptcy reforms. Many may look to this bill as a wedge to use to crack apart the means-test reform. Are there ways in which you think this bill presents a unique circumstance that should not serve as such a precedent for undoing the means test? If so, how can we make that clearer in the legislation?

I firmly believe that means testing is a good thing. As mentioned, there is a moral obligation to repay one's debts if one has the ability to do so. In my opinion, H.R. 4044 is a carefully targeted response to a pressing problem. This Country asks much of its military personnel and their dependents. In order to protect those who protect this Country, while simultaneously protecting the integrity of the bankruptcy system, the bill is designed to provide procedural protections to servicemembers who seek relief under chapter 7 of the Bankruptcy Code. The bill presumes that activated reservists and national guardsmen that file a chapter 7 petition have filed their petitions in good faith. It would then be incumbent upon certain parties in interest, including the U.S. Trustee, and the Bankruptcy Court, to object to chapter 7 relief. A court could then determine in an individualized manner whether, under the totality of the circumstances, a reservist or national guardsmen has engaged in abuse of the bankruptcy process. The bill appears to strike a pragmatic balance to ensure that the bankruptcy process does not unfairly disadvantage our Nation's citizen soldiers.

I agree that several constituencies hope that by this amendment to Section 707, the "camel's nose is in the tent." Many would like to see a repeal or substantial scale-back of the means test. This bill, however, presents a unique circumstance (*see* Situations 1-4 above) that should not serve as precedent for undoing the means test. To reduce the probability of further attempts to scale back the means test, I would recommend a rule approach like that contemplated by H.R. 4044, and eschew reliance on any standard that invites considerable judicial discretion or unnecessary complexity. All Members of Congress should be justifiably proud that they are taking steps to ease the financial burden of this Country's citizen soldiers through targeted and limited relief embodied in H.R. 4044. This bill serves as much needed relief for a very limited number of potential debtors; it is not a ticket to substantial revision of what is an anti-abuse program still well within its infancy.

ANSWERS TO POST-HEARING QUESTIONS FROM ED BOLTZ, THE LAW OFFICES OF JOHN T. ORCUTT, P.C., DURHAM, NC, ON BEHALF OF THE NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Questions for Edward Boltz
From Linda T. Sánchez, Chair

1. You assert that the means test presents particular difficulties for members of the military who receive combat pay. Why can't the servicemember simply explain that his or her temporary receipt of higher income is a special circumstance?

2. You state that establishing special circumstances "requires extensive evidentiary hearings." Please explain.

Response to Questions 1 and 2:

While a servicemember may be able to explain his or her temporary receipt of higher income as a special circumstance, such an explanation will not necessarily be simple. 11 U.S.C. § 707(b)(2)(B)(i) provides that "the presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, to the extent that such special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.[*sic*]"[1] The assertion of "special circumstances" related to the cessation of the servicemember's combat duty could be used to rebut the presumption of abuse, but the burden would be placed on the servicemember to do so and this would not be a simple burden to carry.

The Bankruptcy Code specifically requires at § 707(b)(2)(B)(ii) that a debtor asserting special circumstances fully document the need for "each additional expense or adjustment to income" and provide "a *detailed* explanation" (emphasis added) of the special circumstance. This would require, at a minimum, documentation regarding the servicemember's income prior to his or her deployment to a combat zone, his or her income during the deployment, as well as documentation to establish a basis for determining his or her future income. Particularly for a servicemember who has spent 15 months or longer in Iraq or Afghanistan, obtaining and organizing these documents would by itself be a substantial burden. The assertion of a "special circumstance" may trigger a comprehensive review, beyond that of the mechanical Means Test, of the servicemember's entire financial situation by the United States trustee or Standing Trustee, requiring the servicemember to respond to discovery requests that extend beyond just the scope of a consideration of the "phantom" combat income. If the asserted special circumstances are not accepted by not only the United States trustee and Standing Trustee, but also unsecured creditors, the issue would need to be decided by the bankruptcy court. Given that the allowance of a special circumstance is an intensely fact-based determination, it is unlikely that a bankruptcy court could or would find such a special circumstance existed without conducting an evidentiary hearing to review the required documentation and detailed explanation.

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[1] There appears to be a scrivener's error in the grammar of this section, which has generally been instead read as "the presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, ~~to the extent that such special circumstances~~ that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative."

Further, for a special circumstance to be allowed, there has to be "no reasonable alternative." As one court stated: "Although this presumption may be rebutted, § 707(b) goes on to set this bar extremely high, placing it effectively off limits for most debtors." *In re Haar*, 360 B.R. 759 (Bankr. N.D. Ohio Feb. 20, 2007). *See also In re Hanks*, 2007 WL 60812 (Bankr. D. Utah Jan. 9, 2007) (finding a job loss and lower income at new employment do not constitute special circumstances); *In re Sparks*, 2006 WL 3953348 (Bankr. E.D. Tex. Oct. 18, 2006) (comparing special circumstances to an "unanticipated development"); *In re Ferando*, Case No. 06-81855 (Bankr. D. Neb. Mar. 1, 2007)(finding that fluctuations in income did not constitute special circumstances.) This is especially true as a debtor is required to prove a negative, namely that "no reasonable alternative" exists. For the servicemember returning from combat duty and facing bankruptcy, it could be argued that delaying the filing of his or her bankruptcy for 6-8 months might be a "reasonable alternative," despite the damage that such delay can have on the servicemember's credit, his security clearance, combat readiness, etc. Servicemembers could also be required to show that they had been unable to avail themselves of the protections of the Servicemembers Civil Relief Act, turning a statutory shield that is meant to augment other consumer protections for servicemembers, into a sword to be used against those that need to file bankruptcy.

This high standard, coupled with the detailed documentation and explanation, make reliance on "special circumstances" anything but simple. H.R. 4044 would, however, be a simple and modest statutory exception, in effect directing bankruptcy courts to consider the difficulties faced by a servicemember in the National Guard or Reserves returning from combat duty as a *per se* special circumstance.

3. You state that establishing special circumstances "involves increased cost." Please explain.

4. Approximately how much would a servicemember save in attorneys fees if he or she did not have to be subject to the means test?

Response to Question 3 and 4:

A hearing on the allowance of special circumstances to adjust a servicemember's "Current Monthly Income" would involve testimony from the servicemember, not only as to how his or her income was inflated while on combat duty, but as to his or her current financial situation and prospects for the future. Such testimony, including examination by the United States Trustee, Standing Trustee and Bankruptcy Judge, would likely require at least an hour-long evidentiary hearing. Added to this would be the time preparing the servicemember for such testimony, as well as gathering the required documentation, drafting the detailed explanation of the special circumstances, and correspondence, communication and response to discovery from the United States Trustee or Standing Trustee prior to such hearing. A conservative estimate for the time that would be necessary to rebut the presumption of abuse based on a servicemember's cessation of combat duty would be 5-10 hours. Billed to the servicemember at an hourly rate, this would result in costs somewhere between $750.00 and $2,500.00. This is a substantial cost that a debtor's attorney would include in both setting the fee with a prospective client and determining whether to accept such a case.

Conversely, if a servicemember were not subject to the Means Test, this would substantially reduce the time needed to prepare a bankruptcy petition, which should result in a lower attorney fee, likely to the amounts charged prior to the enactment of BAPCPA.[2] This would be particularly true for Chapter 7 bankruptcy case, where a debtor must pay his or her attorney prior to the filing of the case. As Chapter 13 attorney's fees are overwhelmingly set by the local bankruptcy courts and with the majority of the costs being paid through the Chapter 13 plan, such fees are less likely to be directly impacted by H.R. 4044.

5. Bankruptcy Code §707(b)(2)(D) already provides an exception to the means test for a disabled veteran whose indebtedness was primarily incurred while on active duty. H.R. 4044 would add a further limited exception for certain qualifying members of the National Guard and the Reserve. Do you see any reason why this further exception would be problematic?

Response to Question 5:

The exception for National Guard and Reserve servicemembers returning from combat duty would not be substantially different from the exception for disabled veterans. Both are distinct, narrow, and deserving classes of debtors. Determining the eligibility for either exception, would be a straightforward and simple inquiry, likely requiring little more than review of the servicemember's duty record.[3] As Professor Williams from the American Bankruptcy Institute testified, this exception would likely apply in only 2,000 to 3,000 cases a year. The nature of the service that the "citizen soldiers" of the National Guard and Reserve provide our Nation and the difficulties that they may face upon return from combat duty, are very consistent across this class and make this modest exception particularly appropriate.

6. Apparently, some courts allow a debtor to deal with the phantom income problem by filing a motion dispensing with the requirement to file a schedule of current income mandated by § 521 (a)(1) of the Bankruptcy Code. Why isn't this a satisfactory alternative to the relief provided by H.R. 4044?

Response to Question 6:

Normally a debtor's "Current Monthly Income" is determined, pursuant to 11 U.S.C. §

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[2] These comments regarding attorneys fees are based only on my personal knowledge of the fees charged by attorneys in my area and should be considered accordingly. I am not aware of any comprehensive nationwide review of attorney's fees in Chapter 7 bankruptcy cases since the enactment of BAPCPA. As 28 U.S.C. § 586 (a)(3)(A) makes it a duty of the United States trustee to review compensation of attorneys in bankruptcy cases, the United State trustee may have more comprehensive data.

[3] This can be done quickly on through the Dept. of Defense's website at: https://www.dmdc.osd.mil/scra/owa/home

101(10A)(i), from "the average monthly income from all sources that the debtor receives ..., during the 6-month period ending on ... the last day of the calendar month immediately preceding the filing of the case if the debtor files the schedule of current income required by section 521(a)(1)(B)(ii)...." This schedule is usually referred to as "Schedule I" and discloses a debtor's actual current income, opposed to the historical average "Current Monthly Income." 11 U.S.C. § 521(a)(1)(B)(ii) requires that a debtor file a Schedule I "unless a court orders otherwise".

11 U.S.C. § 101 (10A)(ii) does allow a bankruptcy court to determine another date on which "Current Monthly Income" will be determined if the debtor does not file a Schedule I. Read in conjunction with §521(a)(1)(B)(ii), some courts have excused a debtor from filing a Schedule I, where doing so would result in the debtor having a "Current Monthly Income" that may be substantially higher than the debtor's actual income.

The first case allowing this, to the best of my knowledge, was *In re Ingram*, Case Number 06-02714-8-RDD (Bankr. E.D.N.C. November 20, 2006).[4] This case specifically involved a servicemember who had been on active duty with the National Guard, until his duty was phased out due to reorganization, causing a steep decline in his actual income. In this case, the bankruptcy court excused the filing of a Schedule I and set a different and more accurate dated for the 6-month period for determining the debtor's "Current Monthly Income." The bankruptcy court held that "[i]t appears that the language of § 101(10A) anticipates situations where the debtor would be allowed to be exempt from filing Schedule I, thereby giving the court the opportunity to fix a different date upon which current monthly income would be determined." *Id.* at 2-3.

This is a perfectly apt solution to the problem presented by a discrepancy between a debtor's "Current Monthly Income" and his actual income. The difficulty arises from several quarters, however, with the first being that this approach is not universally accepted or widely known by bankruptcy courts. Other than two other unreported decisions from the Eastern District of North Carolina, the only other bankruptcy court that has allowed this, to the best of my knowledge and research, has been the Middle District of North Carolina, in *In re Montgomery*, 2008 WL 597180 (Bankr. M.D.N.C., March 04, 2008 (NO. 07-51781)). That this solution is not widely known is best addressed through education of the bankruptcy bar, including not only attorneys, but also bankruptcy judges, United States Trustees, and Standing Chapter 7 and Chapter 13 Trustees. Such education does not, however, mean that this approach will be universally accepted, since even in the Eastern District of North Carolina, this solution has been rejected one of the three bankruptcy judges. It is also worth noting that both of the courts that have adopted this approach are in North Carolina, whose bankruptcy courts, along with those in Alabama, are not overseen by the Executive Office of the United States Trustee. Whether this approach would survive when confronted by United States Trustees, who often resistant such "innovations" by debtors, is an open question.

Further, this approach again presents the difficulty for National Guard and Reserve

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[4] I have attached a copy of this opinion with these answers as this case was not published in the Bankruptcy Reporter. I would also note, in full disclosure, my particular pride in this case and this approach to this problem, as it was successfully advanced by my law partner, Joseph Bledsoe, III.

servicemembers, of subjecting them to additional costs and uncertainties. § 521(a)(1)(B) only allows a debtor to avail himself or herself of this solution by failing to file a Schedule I, if "a court orders otherwise...." In order to determine if it is appropriate to excuse the failure to file a Schedule I and reset the "Current Monthly Income" period, a bankruptcy court will be need to hold a hearing to establish the pertinent facts. As discussed above, additional hearings such as this inevitably result in increased attorneys fees, simply due to the increased work required. If the bankruptcy court ultimately declines to excuse a debtor from filing a Schedule I, this can be fatal to the case as Bankruptcy Rule 1007 (c) requires that the schedules be filed within 15 days of the commencement of the case. Failure to do so may be excused, but may also result in dismissal of the case.

Despite these reservations, I do believe that the solution found in *In re Ingram* can be a satisfactory solution to the problems faced by National Guard and Reserve servicemembers returning from combat duty and facing bankruptcy. This is exactly what, H.R. 4044 would, in effect, do. H.R. 40404 would ratify this approach, by removing such servicemembers from the artificial "Current Monthly Income", but still subjecting them to a review for abuse under a "totality of the circumstances" test in Chapter 7 or a "good faith" test in Chapter 13. And it would do so by finding that such servicemembers were a distinct, narrow, and deserving class of debtors that need not be subject to the individual Means Test scrutiny of bankruptcy courts.

Other courts have held that for Chapter 13 cases, the phrase "projected disposable income," as used in § 1325(b)(1)(B), has a different meaning from the amount of "disposable income" that results from the Means Test calculation. "Where it is shown that Form B22C disposable income fails accurately to predict a debtor's actual ability to fund a plan, that figure may be subject to modification." *In re Lanning*, 380 B.R. 17, 25 (10th Cir. BAP (Kan.) December 13, 2007.) Reliance on this solution, however, is problematic as it is only applicable in Chapter 13 proceedings, and not Chapter 7 cases. Additionally, even in Chapter 13 cases, there is a split in authority on whether the phrase "projected disposable income" would allow such a modification of a debtor's "Current Monthly Income".[5] Again, such a solution would subject a servicemember to the time, costs, and uncertainties of a discovery and evidentiary hearing, whereas H.R. 4044 simply recognizes that the difficulties presented by the Means Test for servicemembers in the National Guard and Reserves are distinct and narrow class of debtors, whose circumstances are both consistent throughout their bankruptcies and worthy of separate exclusion from the Means Test.

7. H.R. 4044 is limited to members of the National Guard and the Reserve. Do you think it should also apply to other members of the military?

Response to Question 7:

The same difficulties faced by service members in the National Guard and Reserve regarding the application of the Means Test and the phantom income that is present upon a return from combat duty are also faced by servicemembers in the regular military. A substantial difference being that servicemembers in the National Guard and Reserves are not only protected from loss of employment

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[5] For a summary of this line of case, see *In re Lanning*, 2007 WL 145199 at *5, n. 20. (Bankr. D. Kan. May 5, 2007)

upon return from active duty by the Uniformed Services Employment and Reemployment Rights Act ("USERRA")[6], but are, in fact, entitled to a "position of employment in which the person would have been employed if the continuous employment of such person with the employer had not been interrupted by such service, or a position of like seniority, status and pay." Servicemembers in the regular military, however, simply face a reduction in the income, due to the loss of combat pay, other related compensations, renewed tax obligations, etc.

While the extension of the protections in H.R. 4044 to servicemembers in the regular military might be laudable for these and other reasons, such an extension would dramatically change the scope of this legislation from a distinct and narrow class to a far larger group. Rather than undertake such a large revision of the Means Test, a more restrained and appropriate response would be to first obtain more detailed studies from the Departments of Defense and Justice regarding the impact of the Means Test on servicemembers in the regular military.

H.R. 4044 should, however, be extended to another group that serves, albeit indirectly, in the military, namely the spouses of servicemembers in the National Guard and Reserves. Based on H.R. 4044 as it is currently written, if the spouse of such a servicemember were to file bankruptcy that spouse would still be subject to the Means Test and the servicemember's income while on combat duty would likely be included in the spouse's Means Test. Even more complicated would be the result if the servicemember and his or her spouse filed a joint case, as the servicemember would be excused from the Means Test, whereas his or her spouse would still be subject to it. Since the servicemember's income during the preceding 6-months would be, pursuant to § 101(10A)(A), included in the "Current Monthly Income" for his or her spouse, this would in effect short-circuit the provisions of H.R. 4044. Accordingly, H.R.4044 should be changed so that rather than excusing only "the debtor" it provides this protection to "the debtor and the debtor's spouse."

8. H.R. 4044 provides an exception to the means test for certain servicemembers who leave active service for 180 days. Do you think this period is long enough?

Response to Question 8:

For technical reasons, H.R. 4044 should be amended to extend the period during which the exception is allowed beyond 180 days. 11 U.S.C. § 101(10A)(i) provides that a debtor's "Current Monthly Income" is "the average monthly income from all sources that the debtor receives ..., during the 6-month period ending on ... the last day of the calendar month immediately preceding the filing of the case ...." Because this definition relies on calendar months, rather than a set number of days, the 180 day period from H.R. 4044 could result in time keeping anomalies. For example, assume a servicemember filed a bankruptcy case on January 31, 2008. His or her "Current Monthly Income" would be based on the income received between July 2007 and December 2007, or a period going back 215 day from the date of his or her filing.[7] This could result in a servicemember falling

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[6] 38 U.S.C. § 4301 *et seq.*

[7] This would be longest applicable time period based on this interaction between "calendar months"and days.

outside the protections of H.R. 4044, but still having income from during his combat duty included in his Means Test. For this reason alone, H.R. 4044 should be amended to either at least 216 days or replace the phrase "180-day period" with "the 6-month period ending on the last day of the calendar month immediately preceding the filing of the case."

Additional pragmatic concerns would also argue in favor of a longer period of time for this exception to apply. If this period were too short, it would have the effect of encouraging servicemembers to file bankruptcy during such time period, where they may have otherwise been able to avoid bankruptcy if they had longer to get their finances back in order. Furthermore, 180 days may be too short of a period for a small business owner to revitalize his or her business, for servicemembers to find employment, for spouses returning from war to readjust to married life and the financial consequences of their deployment, or even for the impact of Post-Traumatic Stress Syndrome to rear its head. Accordingly, amending H.R. 4044 to exclude servicemembers in the National Guard or Reserves for 1 to 2 years following their return from combat duty would be reasonable and would serve the dual goals of both helping servicemembers avoid bankruptcy and also providing them with reasonable relief should it be unavoidable.

**Questions for the Record by Ranking Member Chris Cannon,
Subcommittee on Commercial and Administrative Law,
"Hearing on H.R. 4044," Tuesday, April 1, 2008, 2:00 p.m., 2141 Rayburn I**

Questions for Edward Boltz, Esq.:

1. Wouldn't it be better if your members encouraged servicemen and –women to follow and obtain the kinds of prudent financial planning and credit counseling that can help them to avoid financial crises and bankruptcy in the first place? Have your members attempted to diversify into the legal aspects of that kind of counseling?

Response to Question 1:

One of the primary purposes of the National Association of Consumer Bankruptcy Attorneys ("NACBA") is to educate consumer bankruptcy attorneys, not only as to the practice of bankruptcy law, but also in the use of non-bankruptcy laws in providing clients with relief and assistance with there debts and financial problems. This includes training consumer attorneys in prosecuting debt collectors for violations of the Fair Debt Collections Act ("FDCPA"),[1] assisting victims of identity theft and credit fraud under the Fair Credit Reporting Act ("FCRA"),[2] combating abusive lending practices under the Truth In Lending Act ("TILA"),[3] holding deceitful mortgage servicers to account with the Real Estate Settlement Procedures Act ("RESPA"),[4] as well as providing representation under a host of other state and federal statutes. Most notably, in regard to servicemembers, NACBA has actively worked to increase our members' knowledge of the benefits that the Servicemember Civil Relief Act[5] can provide for our clients that are members of the regular military, the National Guard and the Reserves. Furthermore, with the recent sub-prime mortgage crisis, many NACBA members have responded by attempting to work out forbearance agreements and loan modifications for clients facing foreclosure or increases in adjustable rate mortgages, utilizing President Bush's HOPE NOW program. All of these have been topics that have been and continue to be addressed both at recent legal education seminars hosted by NACBA and on the internet discussions hosted NACBA.

In regard to credit counseling, 11 U.S.C. § 109 (h) requires that all debtors participate in credit counseling prior to the filing of bankruptcy. 11 U.S.C. §§ 727 (a)(11) and 1328 (g) further require that debtors attend a financial management course in order to obtain a discharge. In order

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[1] 15 U.S.C. §§ 1692 *et seq.*

[2] 15 U.S.C. §§ 1681 *et seq.*

[3] 15 U.S.C. §§ 1601 *et seq.*

[4] 12 U.S.C. §§ 2601 *et seq.*

[5] 50 U.S.C. §§ 501 *et seq.*

to avoid any conflicts of interest, few consumer debtor's attorney operate their own credit counseling organizations, since doing so could raise questions about whether the attorney was operating the credit counseling organization to give sham certifications under § 109 (g). Additionally, it is not clear that the United States trustee would approve under 11 U.S.C. § 111 a consumer credit counseling agency that was overtly operated by a consumer debtor's attorney. Furthermore, state laws may prohibit or limit for-profit providing credit counseling services.[6]

These restrictions, notwithstanding, most consumer bankruptcy attorneys have established relationships with both credit counseling agencies and financial management instruction courses, many of whom do not charge clients for participation in there counseling or educational services, but only if the client later seeks a certification for bankruptcy. Accordingly, clients are often able to obtain these services with the assistance of consumer attorney without cost.

Consumer bankruptcy attorneys know, perhaps better than anyone, the costs and heartache that are entailed in filing bankruptcy. NACBA and its members work diligently to provide their clients with alternatives to bankruptcy and if those alternatives are not feasible, zealous bankruptcy representation.

2. Do you or NACBA intend to seek other exceptions to or rollbacks of the means test?

Response to Question 2:

H.R. 4044 was proposed by Representatives Janice Schakowsky and Dana Rohrabacher on their own initiative. While NACBA whole-heartedly supports this legislation, it was not drafted at our urging nor was it part of our legislative agenda until our support was solicited by the bill's sponsors.

3. If H.R. 4044 passes, do you or NACBA intend to you use it as a precedent to support other attempts to weaken the means test?

Response to Question 3:

Rather than weakening the Means Test, H.R. 4044 would in fact strengthen it by removing a fundamental unfairness that the mechanical application of the Means Test imposes on servicemembers in the National Guard and Reserves after they return from serving their Nation in combat zones.

Beyond that NACBA will work to continue to play a key role in shaping the outcome of policy-related debates on consumer bankruptcy issues.

4. Do you think reservists and servicemen would be helped or hurt by the higher costs of credit they would face if we made them riskier investments for creditors?

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[6] See for example, N.C.G.S. § 45-423 *et seq.*

Response to Question 4:

The recent study, *The Effect of Bankruptcy Strip-Down on Mortgage Interest Rates*[7], by Professor Adam Levitin and Joshua Goodman examined the impact that allowing modification of home mortgages, change in the Bankruptcy Code far more substantial than H.R. 4044 contemplates, would have on the cost of credit for mortgages. The authors found that "there is no empirical evidence that supports a conclusion that permitting either strip-down or other forms of modification of principal home mortgage loans in bankruptcy would have more than a minor impact on mortgage interest rates or on home ownership rates." Additionally, the number of home-owners that would benefit from allowing modification of home mortgages in Chapter 13 cases, estimated by some to be as many as 600,000, dwarfs the 2,000 - 3,000 servicemembers that Professor Jack F. Williams testified would benefit from H.R. 4044. If allowing modification of home mortgage would have only minor impacts on the cost of credit, it is extremely unlikely that the minor change that would result from H.R. 4044 on the bankruptcy laws would have any impact whatsoever on the cost of credit for servicemembers.

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[7] This paper can be downloaded without charge from the Social Science Research Network Electronic Paper Collection at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087816

SO ORDERED.

SIGNED this 20 day of November, 2006.

Randy D. Doub
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NORTH CAROLINA
FAYETTEVILLE DIVISION

IN RE:	CASE NO.
KENDRICK DURVILLE INGRAM GAIL FLOWERS INGRAM	06-02714-8-RDD
DEBTORS	

ORDER EXCUSING REQUIREMENT THAT DEBTORS FILE SCHEDULE I AND SETTING ALTERNATIVE DATE TO DETERMINE DEBTORS' MONTHLY INCOME

The matter before the court is the debtors' motion to excuse the requirement that they file Schedule I and for an order setting an alternative date to determine their current monthly income under Form B22C. A hearing was held in Fayetteville, North Carolina on November 16, 2006.

At the hearing of this matter, Mr. Ingram testified that prior to filing the petition in this case, he had been employed for five years on active duty with the National Guard, earning approximately $4033.00 per month. Mr. Ingram's duty ended on July 17, 2006 when he was phased out because of a reorganization of his unit. Mr. Ingram had been unemployed for two months at the time of the filing of the petition in this case. During Mr. Ingram's two-month period of unemployment, the debtors fell behind with their debt payments, resulting in their filing this petition on September 1, 2006.

Mr. Ingram began new employment last week at the Mobilization and Training Site at Fort Bragg, grossing approximately $2300.00 per month. He testified that there is room for advancement and raises in his new position. Mrs. Ingram remains employed as a bus driver, grossing approximately $250.00 per month. Because of their current income, the debtors believe that they will be able to make their proposed plan payments.

11 U.S.C. § 1325(b) requires that all of the debtors' disposable income be used to pay unsecured creditors in the Chapter 13 plan. Section 1325(b)(2) defines disposable income as current monthly income less reasonably necessary expenses. Current monthly income is generally determined by averaging the debtors' income for the six-month period prior to their filing the petition. However, 11 U.S.C. § 101(10A)(ii) allows for the court to determine another date on which current monthly income will be determined if the debtor does not file Schedule I. 11 U.S.C. § 521(a)(1)(B)(ii) requires the filing of Schedule I *unless the court orders otherwise.*

In this case, if the debtors' current monthly income were determined consistently with the general definition, it would include the months during which Mr. Ingram was employed with the National Guard. It would not reflect the significant decrease in income the debtors have suffered due to Mr. Ingram's involuntary change in employment. If the debtors were forced to use their pre-petition six-month average as their current monthly income, their plan would not be feasible due to their actual monthly income at this time. The debtors would then be forced to have their case dismissed and refile at a date more amenable to their situation, which would result in additional expenses for all parties involved.

It appears that the language of § 101(10A) anticipates situations where the debtor would be allowed to be exempt from filing Schedule I, thereby giving the court the opportunity to fix a different date

upon which current monthly income would be determined. The court cannot envision a more appropriate situation in which to use this authority than the present one.

For the foregoing reasons, the debtors' motion to excuse the requirement that they file Schedule I is **ALLOWED** and the debtors' current monthly income shall be determined using the six-month period ending on April 30, 2007.

SO ORDERED.

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THE EFFECT OF BANKRUPTCY STRIP-DOWN ON MORTGAGE INTEREST RATES

Adam J. Levitin
Joshua Goodman

GEORGETOWN UNIVERSITY LAW CENTER

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THE EFFECT OF BANKRUPTCY STRIP-DOWN ON MORTGAGE INTEREST RATES: SUMMARY OF INITIAL FINDINGS

ADAM J. LEVITIN†
JOSHUA GOODMAN‡

Executive Summary

This paper summarizes the initial findings of our study on the effect of bankruptcy strip-down and modification on principal home residence mortgage rates. Using data from the 1980s and 1990s, we explore whether mortgage interest rates and origination rates changed as a result of federal judicial rulings on residential mortgage strip-down—the bifurcation of an undersecured mortgage lender's claim into a secured claim for the value of the collateral property and a general unsecured claim for the deficiency.

Our initial results suggest that permitting strip-down has no effect on origination rates and increases mortgage interest rates by only 10-15 basis points, though the latter result is statistically distinguishable from zero only in some specifications. We do, however, find some evidence that allowing strip-down has a larger impact on interest rates in states where Chapter 13 filing is more common. These findings are consistent with current pricing in the primary and secondary mortgage and private mortgage insurance markets, and suggest that permitting bankruptcy modification of mortgages would have no or little impact on mortgage interest rates.

* * * * *

Bankruptcy and Mortgages

The United States bankruptcy system excels at resolving financial distress caused when consumers find themselves overburdened with debt. Although the process can be a painful one, bankruptcy allows creditors an orderly forum to sort out their share of losses and to return the debtor to productivity. Thus for the past thirty years, bankruptcy has been the social safety net for the middle class. The bankruptcy system, however, is incapable of handling the current home mortgage crisis because of the special protection it gives to most residential mortgage claims.

Debtors in Chapter 13 repayment plan bankruptcies are able to modify almost all types of debts, which means they can change interest rates, amortization,

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and term of loans.[1] They can also "strip down" debts secured by collateral to the value of the collateral.[2] Strip-down is the most drastic type of modification because it affects the principal amount of the creditor's claim, not just the interest.

Debtors can modify mortgages on vacation homes, investor properties, and multifamily residences in which the owner occupies a unit.[3] The Bankruptcy Code, however, forbids the modification of mortgage loans secured solely by the debtor's principal residence.[4] Such mortgage loans must be paid off according to their original terms or else the bankruptcy automatic stay will be lifted and the mortgagee can foreclose on the property. As a result, if a debtor's financial distress stems from a home mortgage, bankruptcy is unable to help the debtor retain her home, and foreclosure will occur.

Everybody losses in foreclosure. Lenders are estimated to lose 40% - 50% of their investment in a foreclosure situation,[5] and debtors lose their homes, which disrupts families and communities. Foreclosures depress housing prices throughout

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[1] 11 U.S.C. § 1322(b)(2).

[2] 11 U.S.C. § 506.

[3] *E.g.*, *In re* Scarborough, 461 F.3d 406, 413 (3d Cir. 2006) (permitting strip-down on two unit property in which the debtor resided); Chase Manhattan Mortg. Corp. v. Thompson (*In re* Thompson), 77 Fed. Appx. 57, 58 (2d Cir. 2003) (permitting strip-down on three unit property in which the debtor resided); Lomas Mortg., Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996) (permitting strip-down on three unit property in which the debtor resided); First Nationwide Mortg Corp. v. Kinney (*In re* Kinney), 2000 U.S. Dist. LEXIS 22313, 11-13 (D. Conn. 2000) (permitting modification of a two-unit property in which the debtor resided); Ford Consumer Fin Co. v. Maddaloni (*In re* Maddaloni), 225 B.R. 277, 278 (D. Conn. 1998); *In re* Stivender, 301 B.R. 498, 500 (Bankr. S.D. Ohio 2003) (noting same); Enewally v. Wash. Mut. Bank. (*In re* Enewally), 276 B.R. 643, 652 (Bankr. C.D. Ca. 2002), *rev'd in part on other grounds*, 2002 U.S. Dist. LEXIS 28113 (C.D. Ca. 2002), *upheld on other grounds*, 368 F.3d 1165, 1172 (9th Cir. 2004) (mortgage on rental property that is not the debtor's residence may be modified); *In re* Kimball, 247 B.R. 35 (Bankr. W.D. N.Y 2000); *In re* Del Valle, 186 B.R. 347, 348-50 (Bankr. D. Conn. 1995) (permitting modification of two-unit property, where the debtor lived on one unit and rented the other); Adebanjo v. Dime Sav. Bank, FSB (*In re* Adebanjo), 165 B.R. 98, 100 (Bankr. D. Conn. 1994) (permitting bifurcation on three-unit property containing the debtor's residence); *In re* McGregor, 172 B.R. 718, 721 (Bankr. D. Mass. 1994) (permitting modification of a mortgage of a four-unit apartment building in which the debtor resided); *In re* Spano, 161 Bankr. 880, 887 (Bankr. D. Conn. 1993); Zablonski v. Sears Mortgage Corp. (*In re* Zablonski), 153 Bankr. 604, 606 (Bankr. D. Mass. 1993) (mortgage encumbering a two family home was not protected from modification); *In re* McVay, 150 Bankr. 254, 256-57 (Bankr. D.Or. 1993) (a mortgage encumbering a bed and breakfast, which was the debtor's principal residence but which had "inherent income producing potential," was not protected from modification).

[4] 11 U.S.C. § 1322(b)(2). Section 1322(b)(2) provides that a plan of reorganization may not "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence..." Since 2005, section 101(13A) of the Bankruptcy Code has defined "debtor's principal residence" as "a residential structure, including incidental property, without regard to whether that structure is attached to real property and...includes an individual condominium or cooperative unit, a mobile or manufactured home or trailer." 11 U.S.C. § 101(13A). State law, however, still determines what is "real property."

[5] Comments of Treasury Secretary Henry Paulson, Ask the White House, *at* http://www.whitehouse.gov/ask/20071207.html. Because many mortgages are held by securitization trusts, the losses to holders of trust securities will vary by tranche.

entire neighborhoods, hurt local businesses, erode state and local government taxes base, impose significant costs on local governments, and foster crime.[6] Foreclosures also have a racially disparate impact because African-Americans invest a higher share of their wealth in their homes and are also more likely than financially similar whites to have subprime loans.[7]

The policy presumption behind bankruptcy's special protection for home mortgage lenders is that it enables them to offer lower interest rates and thus encourages home ownership. As Justice Stevens noted:

> At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than to other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market.[8]

Thus, the policy special treatment of principal home mortgages in bankruptcy is based on an economic assumption.

Testing the Economic Assumption Behind the Bankruptcy Code's Anti-Modification Provision

Fortunately, the economic assumption behind the Bankruptcy Code's anti-modification provision can be tested empirically. After the effective date of the

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[6] *See, e.g.*, Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POLICY DEBATE 57 (2006); Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUDIES, 851 (2006); Mark Duda & William C. Apgar, *Mortgage Foreclosures in Atlanta: Patterns and Policy Issues*, A Report Prepared for NeighborWorks America, December 15, 2005, *at* www.nw.org/Network/neighborworksprogs/foreclosuresolutions/documents/foreclosure1205.pdf; William C. Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom*, May 11, 2005, *at* http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf; William C. Apgar *et al.*, *The Municipal Cost of Foreclosures: A Chicago Case Study*, Feb. 27, 2005, Homeownership Preservation Foundation Housing Finance Policy Research Paper Number 2005-1, *at* www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf; Amy Ellen Schwartz *et al.*, *Does Federally Subsidized Rental Housing Depress Neighborhood Property Values?*, NYU Law School Law and Economics Research Paper No. 05-04; NYU Law School, Public Law Research Paper No. 05-02 (Mar. 2005).

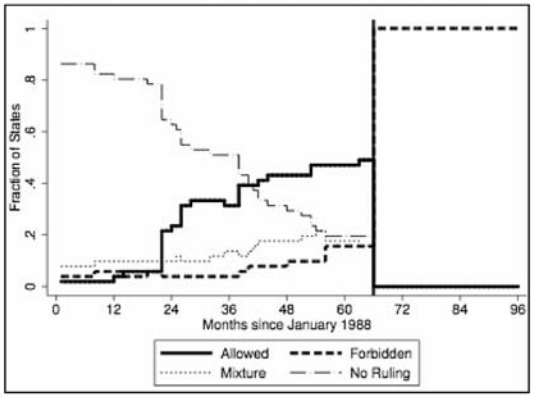
[7] MELVIN L. OLIVER & THOMAS M. SHAPIRO, BLACK WEALTH, WHITE WEALTH: A NEW PERSPECTIVE ON RACIAL INEQUALITY 66 (2006) (housing equity accounted for 62.5% of all black assets in 1988, but only 43.3% of white assets, even though black homeownership rates were 43% and white homeownership rates were 65%).

[8] Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993) (Stevens, J., concurring). For discussion of the policy debate *see* Grubbs v. Houston First Am. Sav. Assoc., 730 F.2d 236, 246 (5th Cir. 1984) (citing Hearings Before the Subcommittee on Improvements of the Judicial Machinery of the Senate Committee on the Judiciary, 95th Cong., 1st Sess. (1977) (pp. 652-53 (Wiese), 703, 707, 714-15 (discouragement of savings and loan associations making home loans), 719-21 (Kulik, National Association of Real Estate Investment Trusts)).

Bankruptcy Code in 1979, but prior to the Supreme Court's *Nobelman* decision in 1993,[9] federal judicial districts varied as to whether they granted home mortgage lenders protection against "strip-down"—the reduction of the mortgage lender's secured claim from the amount outstanding on the loan to the value of the home. [10] This variation between districts in the timing and results of their decisions allowed us to isolate the effects of allowing strip-down on home mortgage interest rates.

Figure 1 shows the fraction of states subject to various categories of strip-down rulings, starting in January 1988. At that point, very few courts had issued published rulings on the principal residence mortgage strip-down issue, so that nearly all states are categorized as "no ruling". Over the next few years, roughly half the states became subject to judicial rulings allowing strip-down, while less than one-fifth were subject to rulings forbidding strip-down. Some states had multiple, conflicting rulings among federal judicial districts.[11] These are labeled "mixture". The *Nobelman* decision, marked by a vertical line, then forbade strip-down in all states.

Figure 1. Published Strip-Down Rulings by Percentage of States



[9] 508 U.S. 324.

[10] Strip-down is synonymous with "lien-stripping" and "cramdown". Because cramdown has a distinct meaning in the context of chapter 11 bankruptcies, we use the term strip-down.

[11] States contain between one and four federal judicial districts. We have treated the District of Columbia as equivalent to a state. Our data set does not cover Puerto Rico or other Unites States territories.

To quantify the effects of these rulings on the mortgage market, we used data from the Monthly Interest Rate Survey conducted by the Federal Housing Finance Board, which "asks a sample of mortgage lenders to report the terms and conditions on all single-family, fully amortized, purchase-money, nonfarm loans that they close during the last five business days of the month."[12] We constructed five outcomes based on the set of loans reported within each state and month cell: the 20th percentile interest rate, the median interest rate, the 80th percentile interest rate, the number of loans reported, and the total dollar value of those loans. Each data point is thus constructed on the state-month level.

We used the period 1988-1995, which thus exploits both the lower court rulings with differential timing and the *Nobelman* ruling that impacts all states simultaneously. We regressed the outcomes on state fixed effects, which control for any factors constant within a state over the period studied, and month fixed effects, which control for any factors constant across the country within a given month. This guarantees that our results are driven neither by correlation between strip-down rulings and country-wide factors (*i.e.*, if strip-down rulings tended to occur during recessions) nor by correlation between strip-down rulings and states' fixed characteristics (*i.e.*, if states allowing strip-down always had unusually high interest rates). In particular, state fixed effects controls for legal variation among states, such as the availability of deficiency judgments and non-judicial foreclosure.

The driving variation is represented by a variable "strip-down," which takes a value of 0 for each state in a given month subject to a court ruling forbidding strip-down and 1 for each state in a given month subject to a court ruling allowing strip-down. For states in months prior to any court rulings on strip-down, we tested three separate possibilities. First, we omitted such cases from the data as missing, which involves the least potential measurement error. Second, we ran regressions assuming that in states and months without rulings, strip-down was forbidden. Third, we assumed that in such cases, strip-down was allowed.

We believe the first assumption to be the most accurate. We interviewed several long-serving or retired bankruptcy judges around the country, all of whom told us that actual practice varied considerably among districts in the absence of published opinions. Accordingly, it is not sound to assume any particular practice in the absence of a published opinion. Nevertheless, our most reliable results turn out to be reassuringly robust to the choice of assumption made.

All regressions discussed below include the state and month fixed effects mentioned above, as well as state-month unemployment rates to control for contemporaneous economic conditions. Inclusion of this control has little effect on our point estimates, suggesting that the effect we measure is not due to a correlation with state-level economic conditions. We computed standard heteroskedasiticty robust standard errors, and clustered by state to allow for

[12] Federal Housing Finance Board. Monthly Interest Rate Survey, *at* http://www.fhfb.gov/Default.aspx?Page=8.

arbitrary correlations in the error term, such as within-state serial correlation that is likely present.

Table 1a shows the results from such regressions. The top panel relates outcomes to the contemporaneous state of the law, while the bottom panel relates outcomes to the law six months prior. Columns (1)-(3) contain the effective interest rate outcomes. Most important are the results from column (2), the median effective interest rate observed.

In each column within each subpanel there are four numbers. The topmost number, the point estimate, is the coefficient of our regression. It represents our best estimate of the actual effect being measured. The second number, listed in parentheses, is the standard error. The standard error, multiplied by approximately two and added and subtracted from the point estimate provides a range—the confidence interval—of two standard deviations from the point estimate in which we can be 95% certain that the true regression coefficient lies.

Some of the standard errors feature one or two asterisks. The asterisks represent whether the confidence interval includes zero. One asterisk means we are 90% certain that the confidence interval does not include zero (marginal statistical significance), while two asterisks means we are 95% certain (statistical significance) that zero is not within the range of possible coefficients. When the standard error does not have an asterisk, it means we are less than 90% certain that the confidence interval does not include zero. The third number, N, is the number of observations upon which we conducted our regression analysis, and the fourth number, R^2, is the proportion of variability in our data that is explained by our model, with 1.0 being 100%.

The top panel of Table 1a suggests that the effect of allowing strip-down is to raise the median interest rate, regressed in column (2), by 11 basis points, though the effect is only marginally significant and only in one specification. The bottom panel's results are somewhat more precise, suggesting that 6 months after strip-down is allowed, the median interest rate is 15 basis points higher, again with marginal statistical significance. Columns (4) and (5) show no consistent or statistically significant pattern, suggesting that strip-down has no obvious effect on the quantities transacted in the mortgage market.

Table 1a. Effects of Permitting Bankruptcy Strip-Down on Mortgage Interest Rates and Originations

	(1) Interest Rate (20)	(2) Interest Rate (50)	(3) Interest Rate (80)	(4) Ln(number of loans)	(5) Ln(volume of loans)
Contemporaneous effect of rulings					
No ruling = strip-down unknown					
Strip-down	0.205	0.110	0.048	0.172	0.158
	(0.156)	(0.105)	(0.073)	(0.153)	(0.165)
N	2690	2690	2690	2690	2690
R^2	0.862	0.849	0.924	0.931	0.932
No ruling = strip-down forbidden					
Strip-down	0.119	0.111*	0.046	-0.030	-0.015
	(0.094)	(0.062)	(0.048)	(0.071)	(0.072)
N	4782	4782	4782	4782	4782
R^2	0.833	0.875	0.932	0.916	0.918
No ruling = strip-down allowed					
Strip-down	0.045	0.038	0.043	0.117	0.140
	(0.118)	(0.088)	(0.032)	(0.096)	(0.100)
N	4782	4782	4782	4782	4782
R^2	0.832	0.874	0.932	0.916	0.919
Six-month lagged effect of rulings					
No ruling = strip-down unknown					
Strip-down	0.270**	0.150*	0.071	0.057	0.043
	(0.133)	(0.081)	(0.090)	(0.134)	(0.140)
N	2692	2692	2692	2692	2692
R^2	0.781	0.820	0.916	0.931	0.934
No ruling = strip-down forbidden					
Strip-down	0.160*	0.116**	0.071*	-0.038	-0.040
	(0.089)	(0.056)	(0.038)	(0.060)	(0.060)
N	4791	4791	4791	4791	4791
R^2	0.842	0.893	0.941	0.916	0.919
No ruling = strip-down allowed					
Strip-down	0.086	0.059	0.040	0.062	0.069
	(0.117)	(0.067)	(0.041)	(0.138)	(0.139)
N	4791	4791	4791	4791	4791
R^2	0.841	0.892	0.941	0.916	0.919

Regressions include state and month fixed effects, and state unemployment rates.
Robust standard errors are clustered by state (* p<.10, ** p<.05).

Table 1b collapses the monthly data into annual data and uses annual state-level bankruptcy filing volumes as outcomes. Neither the contemporaneous nor the lagged version of the strip-down variable seems to have any impact on the number of (non-business) bankruptcy filers, the number of (non-business) Chapter 13 filers, nor the proportion of filers who file under Chapter 13. Taken as a whole, Tables 1a

and 1b suggest that allowing strip-down has a small (10-15 basis point) impact on interest rates, but no impact on the volume of mortgage transactions nor on the propensity of people to file for bankruptcy.

Table 1b. Effects of Permitting Bankruptcy Strip-Down on Bankruptcy Filings

	(1) Ln(nonbusiness all filings)	(2) Ln(nonbusiness Ch. 13 filings)	(3) Proportion Ch. 13 filings
Contemporaneous effect of rulings			
No ruling = strip-down unknown			
Strip-down	0.053	-0.013	-0.013
	(0.057)	(0.129)	(0.022)
N	252	252	252
R^2	0.995	0.991	0.979
No ruling = strip-down forbidden			
Strip-down	0.028	0.037	0.002
	(0.034)	(0.065)	(0.008)
N	408	408	408
R^2	0.990	0.983	0.968
No ruling = strip-down allowed			
Strip-down	-0.050	-0.076	-0.020
	(0.061)	(0.122)	(0.018)
N	408	408	408
R^2	0.990	0.983	0.969
Six-month lagged effect of rulings			
No ruling = strip-down unknown			
Strip-down	0.044	0.041	-0.008
	(0.040)	(0.106)	(0.015)
N	234	234	234
R^2	0.997	0.992	0.981
No ruling = strip-down forbidden			
Strip-down	0.033	0.044	0.004
	(0.039)	(0.066)	(0.007)
N	408	408	408
R^2	0.990	0.983	0.968
No ruling = strip-down allowed			
Strip-down	-0.030	0.001	-0.014
	(0.065)	(0.133)	(0.015)
N	408	408	408
R^2	0.990	0.983	0.968

Regressions include state and year fixed effects, and state unemployment rates.
Robust standard errors are clustered by state (* p<.10, ** p<.05).

Table 2a runs the same regressions as in Table 1a, but with an extra term, the interaction between the strip-down variable and the state's proportion of

bankruptcy filers filing under Chapter 13 in 1988. The idea here is to test whether strip-down rulings have a bigger impact in states where more people tend to file under Chapter 13. Table 2a suggests that this is in fact true. The coefficient on the interaction term in column (2) of the top panel is positive and significant, implying that every 10 percentage point rise in the proportion of filers using Chapter 13 leads to a 17 basis point higher impact of allowing strip-down. In future work, we hope to explore this heterogeneity in more detail, as it may provide further insight into the role that strip-down and bankruptcy risks have in determining interest rates.

Table 2b similarly replicates Table 1b, and again shows little evidence that strip-down affects bankruptcy filing rates (if anything, strip-down is associated with lower filing rates, a somewhat counterintuitive result).

Table 2a. Effect of Permitting Bankruptcy Strip-Down on Mortgage Interest Rates and Originations (interacted with Chapter 13 proportion)

	(1) Interest Rate (20)	(2) Interest Rate (50)	(3) Interest Rate (80)	(4) Ln(number of loans)	(5) Ln(volume of loans)
Contemporaneous effect of rulings					
	No ruling = strip-down unknown				
Strip-down	-0.311	-0.183	-0.083	0.126	0.118
	(0.235)	(0.150)	(0.092)	(0.246)	(0.252)
Strip-down * Proportion Ch. 13	0.295**	0.168**	0.075**	0.026	0.022
	(0.096)	(0.062)	(0.035)	(0.116)	(0.112)
N	2690	2690	2690	2690	2690
R^2	0.808	0.852	0.925	0.931	0.932
	No ruling = strip-down forbidden				
Strip-down	-0.215	-0.089	-0.069	-0.048	-0.050
	(0.163)	(0.106)	(0.064)	(0.121)	(0.117)
Strip-down * Proportion Ch. 13	0.192**	0.115**	0.066**	0.022	0.020
	(0.067)	(0.044)	(0.025)	(0.055)	(0.051)
N	4782	4782	4782	4782	4782
R^2	0.835	0.876	0.933	0.916	0.918
	No ruling = strip-down allowed				
Strip-down	0.039	0.045	0.003	0.097	0.096
	(0.139)	(0.098)	(0.048)	(0.125)	(0.135)
Strip-down * Proportion Ch. 13	0.003	-0.004	-0.011	0.010	0.017
	(0.037)	(0.020)	(0.018)	(0.047)	(0.052)
N	4782	4782	4782	4782	4782
R^2	0.832	0.874	0.932	0.916	0.919
Six-month lagged effect of rulings					
	No ruling = strip-down unknown				
Strip-down	-0.246	-0.110	-0.019	0.109	0.167
	(0.217)	(0.132)	(0.100)	(0.202)	(0.203)
Strip-down * Proportion Ch. 13	0.295**	0.149**	0.052*	-0.047	-0.071
	(0.087)	(0.059)	(0.030)	(0.101)	(0.099)
N	2692	2692	2692	2692	2692
R^2	0.788	0.833	0.916	0.931	0.934
	No ruling = strip-down forbidden				
Strip-down	-0.207	-0.053	0.009	0.018	0.050
	(0.145)	(0.098)	(0.056)	(0.094)	(0.086)
Strip-down * Proportion Ch. 13	0.211**	0.097**	0.036*	-0.033	-0.051
	(0.056)	(0.040)	(0.022)	(0.042)	(0.039)
N	4791	4791	4791	4791	4791
R^2	0.844	0.893	0.942	0.917	0.920
	No ruling = strip-down allowed				
Strip-down	0.024	0.068	0.080	0.066	0.065
	(0.145)	(0.081)	(0.065)	(0.155)	(0.163)
Strip-down * Proportion Ch. 13	0.031	-0.004	-0.020	-0.002	0.002
	(0.038)	(0.019)	(0.021)	(0.041)	(0.046)
N	4791	4791	4791	4791	4791
R^2	0.841	0.892	0.941	0.916	0.919

Regressions include state and month fixed effects, and state unemployment rates.
Robust, clustered errors are clustered by state (* p<.10; ** p<.05).

Table 2b. Effects of Permitting Bankruptcy Strip-Down on Bankruptcy Filings (interacted with Chapter 13 proportion)

	(1) Ln(nonbusiness all filings)	(2) Ln(nonbusiness Ch. 13 filings)	(3) Proportion Ch. 13 filings
Contemporaneous effect of rulings			
No ruling = strip-down unknown			
Strip-down	0.049	-0.069	-0.015
	(0.098)	(0.193)	(0.025)
Strip-down * Proportion Ch. 13	0.002	0.033	0.001
	(0.036)	(0.071)	(0.009)
N	252	252	252
R^2	0.993	0.991	0.979
No ruling = strip-down forbidden			
Strip-down	0.080*	0.150	0.012
	(0.044)	(0.100)	(0.012)
Strip-down * Proportion Ch. 13	-0.030**	-0.066*	-0.006
	(0.013)	(0.036)	(0.006)
N	408	408	408
R^2	0.990	0.983	0.968
No ruling = strip-down allowed			
Strip-down	-0.076	-0.143	-0.011
	(0.078)	(0.139)	(0.019)
Strip-down * Proportion Ch. 13	0.018	0.035	-0.005
	(0.018)	(0.031)	(0.005)
N	408	408	408
R^2	0.990	0.983	0.969
Six-month lagged effect of rulings			
No ruling = strip-down unknown			
Strip-down	0.022	-0.004	-0.004
	(0.063)	(0.167)	(0.019)
Strip-down * Proportion Ch. 13	0.013	0.026	-0.002
	(0.023)	(0.052)	(0.009)
N	234	234	234
R^2	0.997	0.992	0.981
No ruling = strip-down forbidden			
Strip-down	0.054	0.171	0.016
	(0.060)	(0.167)	(0.011)
Strip-down * Proportion Ch. 13	-0.030	-0.075**	-0.007
	(0.019)	(0.037)	(0.006)
N	408	408	408
R^2	0.990	0.983	0.968
No ruling = strip-down allowed			
Strip-down	-0.047	-0.047	-0.003
	(0.082)	(0.151)	(0.015)
Strip-down * Proportion Ch. 13	0.009	0.025	-0.005
	(0.017)	(0.028)	(0.004)
N	408	408	408
R^2	0.990	0.983	0.969

Regressions include state and year fixed effects, and state unemployment rates.
Robust standard errors are clustered by state (* p<.10, ** p<.05).

Market Observational and Empirical Confirmations of Our Findings

The results of our historical analysis of the impact of strip-down conform to present market observational measures: current mortgage interest rates variation by property type, current private mortgage insurance premiums, and Freddie Mac/Fannie Mae delivery fee premium spread by property type.

(1) Mortgage Interest Rate Variation by Property Type

Section 1322(b)(2) prevents modification only on mortgages secured solely by real property that is the debtor's principal residence. This means that mortgages on second or vacation homes, on multifamily properties, and on rental or investor properties may currently be modified (including strip down).[13]

Using on-line rate quote generators we tested current mortgage pricing on six types of properties: owner-occupied single-family principal residences; single-family second homes; owner-occupied two-family residences; owner-occupied three-family residences; owner-occupied four-family residences; and investor properties—to see if it reflected variations in bankruptcy modification risk.[14] We obtained the quotes from four major mortgage lenders: eLoan, IndyMac, JPMorgan Chase, and Wachovia. These lenders were selected because their on-line quote generators did not require disclosure our personal information. The quotes were generated between January 17, 2008 and January 27, 2008.

Using the on-line quote generators, we tested 530 mortgage rate quotes from in eleven states. Our quotes divided into two subsamples. First we took a standardized sampling of 288 quotes in three states: California, Massachusetts, and Pennsylvania. We chose Massachusetts and Pennsylvania because of the clarity of the law in those states, which are located in the jurisdictions of the United States Courts of Appeals for the First and Third Circuits, respectively. There is unambiguous circuit level law in both the First and Third Circuits permitting the strip-down of mortgages on all multi-unit residences.[15] We included California both because it is the largest single state mortgage market and because it has been hit particularly hard by the mortgage crisis.

For this three-state sample we obtained 288 quotes for 30-year fixed-rate, first-lien purchase money mortgages, the most common traditional mortgage product. We tested assuming a loan-to-value (LTV) ratio of 80%, representing a 20% down payment. Half of the quotes obtained were for loan amounts within the GSE conforming limits, and half were for non-conforming "jumbos." The conforming quotes were for loan amounts based on the average mortgage loan amount in the state. The quotes for the jumbos were for loan amounts slightly higher than the

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[13] *See supra* note 3.

[14] The reliability of on-line quotes was confirmed in interviews with veteran mortgage brokers.

[15] *In re* Scarborough, 461 F.3d 406, 413 (3d Cir. 2006); Lomas Mortg., Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996).

conforming limit for a 3-family residence.[16] For each of the six types of residences we recorded the quoted interest rate, points, and APR for the lowest APR quotation.

For IndyMac and eLoan, we obtained a full set of quotes for each of three different credit scores: 760, 660, and 560, representing prime, Alt-A, and subprime borrowers respectively. For JPMorgan Chase and Wachovia, we were not able to test for specific credit scores and have assumed that the single set of quotes generated are for prime borrowers, based on rate comparisons with IndyMac and eLoan.[17] Accordingly, in each state we tested thirty-six quotes for IndyMac and eLoan and twelve for JPMorgan Chase and Wachovia, for a total of 96 quotes per state and 288 quotes total. Table 3 provides an illustrative example of the data. It shows the rate quotes generated by IndyMac on January 27, 2008 for conforming mortgages in California with 20% down.

As a cross-check on our ability to extrapolate from 30-year fixed-rate, first-lien purchase money mortgage rate quotes in California, Massachusetts, and Pennsylvania, we also tested an additional non-scientific sample of 242 quotes from those three states as well as from eight additional states: Illinois, Florida, Maryland, Michigan, Missouri, Ohio, Nevada, and Texas. In this sample we tested at a variety of credit scores, ranging from 540 to 760, a range of LTV ratios from 90% to 70%, a variety of property values, as well as other mortgage products, such as 15-year fixed mortgages, 2/1 and 5/1 LIBOR ARMs, and interest-only mortgages.

[16] By testing just above the conforming limit for 3-family residences, all of our 4-family residence quotes ended up being for conforming properties because of the higher conforming loan limit for 4-family residences. We tested just above the 3-family limit out of concern that the loan amount necessary for a 4-family jumbo might be so large as to distort our results for single- and two-family properties. Since there is no difference in legal treatment of three-family and four-family residences, we do not believe that the absence of four-family jumbos from our sampling is significant.

[17] JPMorgan Chase permits specification of credit by characterization (excellent, good, fair, etc.), but not by score. We used "excellent" as our assumption.

Table 3. IndyMac Mortgage Interest Rate Quotes on January 27, 2008

	Single Family Primary Residence	2 Family Primary Residence	3 Family Primary Residence	4 Family Primary Residence	Vacation Home or Second Home	Investor or Rental Property
State of Property	CA	CA	CA	CA	CA	CA
Lender	IndyMac	IndyMac	IndyMac	IndyMac	IndyMac	IndyMac
Credit Score	560	560	560	560	560	560
Conforming?	Y	Y	Y	Y	Y	Y
Property Value	$400,000.00	$400,000.00	$400,000.00	$400,000.00	$400,000.00	$400,000.00
Loan Amount	$320,000.00	$320,000.00	$320,000.00	$320,000.00	$320,000.00	$320,000.00
Loan Term	30-Fixed	30-Fixed	30-Fixed	30-Fixed	30-Fixed	30-Fixed
Interest Rate	7.250%	7.250%	7.250%	7.250%	7.250%	8.250%
Points	0.858%	0.858%	0.858%	0.808%	0.858%	0.711%
APR	7.414%	7.414%	7.414%	7.383%	7.414%	8.408%
	Single Family Primary Residence	**2 Family Primary Residence**	**3 Family Primary Residence**	**4 Family Primary Residence**	**Vacation Home or Second Home**	**Investor or Rental Property**
State of Property	CA	CA	CA	CA	CA	CA
Lender	IndyMac	IndyMac	IndyMac	IndyMac	IndyMac	IndyMac
Credit Score	660	660	660	660	660	660
Conforming?	Y	Y	Y	Y	Y	Y
Property Value	$400,000.00	$400,000.00	$400,000.00	$400,000.00	$400,000.00	$400,000.00
Loan Amount	$320,000.00	$320,000.00	$320,000.00	$320,000.00	$320,000.00	$320,000.00
Loan Term	30-Fixed	30-Fixed	30-Fixed	30-Fixed	30-Fixed	30-Fixed
Interest Rate	5.750%	5.750%	5.750%	5.750%	5.750%	6.750%
Points	0.868%	0.868%	0.868%	0.868%	0.868%	1.045%
APR	5.900%	5.900%	5.900%	5.900%	5.900%	6.928%
	Single Family Primary Residence	**2 Family Primary Residence**	**3 Family Primary Residence**	**4 Family Primary Residence**	**Vacation Home or Second Home**	**Investor or Rental Property**
State of Property	CA	CA	CA	CA	CA	CA
Lender	IndyMac	IndyMac	IndyMac	IndyMac	IndyMac	IndyMac
Credit Score	760	760	760	760	760	760
Conforming?	Y	Y	Y	Y	Y	Y
Property Value	$400,000.00	$400,000.00	$400,000.00	$400,000.00	$400,000.00	$400,000.00
Loan Amount	$320,000.00	$320,000.00	$320,000.00	$320,000.00	$320,000.00	$320,000.00
Loan Term	30-Fixed	30-Fixed	30-Fixed	30-Fixed	30-Fixed	30-Fixed
Interest Rate	5.375%	5.375%	5.375%	5.375%	5.375%	6.500%
Points	1.545%	1.545%	1.545%	1.545%	1.545%	0.771%
APR	5.585%	5.585%	5.585%	5.585%	5.585%	6.618%

The samplings produced three general rate quote patterns that did not vary by either state or mortgage product type. First, for all conforming mortgage loans with 20% down payments from eLoan, IndyMac, and Wachovia, there was no difference within each credit score between the quotes offered for single-family primary residences, vacation homes, or any multi-family unit in which one unit is owner occupied. Interest rates, points, and APRs were identical for these property types, despite the variation in bankruptcy modification risk. Uniformly, however, investor properties had higher interest rates and points. Because investor properties share the same bankruptcy modification risk as vacation homes and multifamily residences, the mortgage rate premium on investor properties cannot be attributed to bankruptcy modification risk.[18]

Chase rate quotes for conforming 20% down mortgages presented a variation on this pattern. Single-family principal residences, vacation homes, and four-family residences had identical quotes, but two- and three-family residences were priced around 25 basis points higher, and 30-year fixed quotes were unavailable for investor properties. With all four lenders, single-family primary residences, which are not modifiable in bankruptcy, were priced the same as vacation homes and at least one of the multi-family residences, which are modifiable in bankruptcy.

When we reduced the down payment to 10% on conforming mortgages, a slightly different pattern emerged. First, rate quotes were not always available with subprime credit scores (560 and 540). Second, for prime and Alt-A credit scores, there were four tiers of pricing by property type. Single-family principal residences and two-family owner-occupied properties were priced identically. Vacation homes also had the same interest rates and points, but APRs were about 10 basis points higher because of additional private mortgage insurance premiums. Investor properties and three- and four-family owner-occupied residences had significantly higher APRs (around 150 and 250 basis points respectively).

Again, Chase rate quotes were different. At 10% down, rate quotes were still unavailable for investor properties for 30-year fixed mortgages. Rates for vacation home mortgages were actually slightly lower (5 basis points) than for single-family principal residences. Notably, interest rates and points for two-family residences were the same as for single-family principal residences, but APRs were higher, by 38 basis points. The source of the APR variation was unclear.

When we tested jumbos, Wachovia followed its price pattern for conforming loans at 80% LTV, and did not differentiate among property types except for investor properties. At 90% LTV, investor property quotes were unavailable, and

[18] It is not surprising that vacation homes have the same rates as single-family principal residences. Vacation homes reputedly have lower default rates because typically only well-heeled buyers purchase them. They do not have tenant risks such as vacancy, non-payment, or damage, and they are typically well-maintained because of the pride of ownership factor.

Multifamily residences in which the owner resides carry the same tenant risks as investor properties. We do not have default rate data on multifamily residences, but owner residency likely reduces default risk and ensures reasonable property maintenance.

the interest rate and points were the same for all other property types. The APR, however, was lower for single-family properties at 90% LTV ratio, though, because of the higher closing costs for the other property types due to items such as higher appraisal fees.

For Chase, jumbo quotes were only available at 80% LTV. For single-family principal residences the quotes were identical to those for two-family residences. Vacation homes were quoted slightly higher, and three- and four-family and investor property quotes were unavailable from Chase for jumbos.

IndyMac and eLoan had a different pattern for jumbos. First, quotes were simply unavailable for subprime credit scores with 10% or 20% down payments, and for some Alt-A products. We were only able to generate quotes when we significantly increased down payments. Second, a three-tier rate spread emerged for prime borrowers depending on property type. Single-family principal residences were priced the lowest. Vacation homes and two-family properties were priced with slightly higher interest rates, but lower points, and APRs (the unit price) that were approximately 8-12 basis points higher.[19] Finally we were unable to obtain rate quotes for jumbo mortgages on three- or four-family properties or investor properties with 20% down or less. As with the subprime and Alt-A mortgages, we were able to get quotes when we decreased the LTV ratio.

The major insight from these rate quotes is that current mortgage rates evince an indifference to bankruptcy modification risk, at least among conforming loans. Regardless of the LTV ratio, there was no difference among conforming loans between the rates for single-family owner-occupied properties, which cannot currently be modified in bankruptcy, and those for two-family owner-occupied properties, which may currently be modified. This means that the rate differences that emerge at 90% LTV ratios between single and two-family owner occupied residences and other property types are not attributable to bankruptcy modification risk.

For both conforming and jumbo products, the higher interest rates for three- and four-family properties and investor properties are a function of risks other than bankruptcy modification. Mortgages on three- and four-family residences may carry higher prices at low LTV ratios because of higher default rates given the difficulties in managing income-producing properties for amateur landlords and the extremely limited foreclosure sale market for these properties outside of a few urban areas.[20] Likewise, the higher interest rates and points required on investor properties at all LTV ratios are explained by higher default rates on investor properties, the greater likelihood of investor properties being non-recourse, and the more limited secondary market for investor property mortgages. Investor properties have inherently greater default risk in part because an investor has the additional rent or mortgage expense that an owner-occupier does not. Investor properties also carry a variety of

[19] On $500,000 30-year 6% fixed mortgage, this translates into an additional $3.00-$3.59.

[20] Chase's outlier pricing for four-family conforming loans is puzzling in this regard.

tenant risks—vacancy, non-payment, and damage. Because investor properties mortgages are often financed through rental payments, tenant risk adds to the default risk.

GSE conforming mortgages have the same bankruptcy modification risk as jumbos. Therefore, it seems unlikely that the small difference in the APR between single-family and two-family owner-occupied properties for some lenders' jumbo mortgages relate to bankruptcy modification risk. We suspect it is a function of the significantly smaller secondary market for jumbos, particularly for two-family owner-occupied properties.

While there is variation in rate quote patterns among the four lenders surveyed, all four lenders provided identical quotes for single-family owner-occupied properties, which cannot be modified in bankruptcy and certain types of multi-family properties, all of which can be modified in bankruptcy. This indicates that current mortgage pricing variations by property type do not reflect bankruptcy modification risk. It appears that current mortgage rate pricing strongly indicates that mortgage lending markets are indifferent to bankruptcy modification risk, a conclusion confirmed by private mortgage insurance pricing.

(2) Private Mortgage Insurance Rate Premiums

Private mortgage insurance is required for all mortgages on which there is less than 20% down payment. The borrower pays the PMI premiums, but the lender is the insurance payee. Private mortgage insurers stand in the mortgage lender's shoes and assume all the risks that the mortgage lender bears, with three exceptions: PMI policies typically have exclusions for strip-down, fraud, and special hazards, such as earthquakes and floods.[21]

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[21] Andrew Lipton & Shiv Rao, *Valuing Lender-Paid Mortgage Insurance in MBS and ABS Transactions*, Moody's Investor Service Special Report, Feb. 9, 2001, *available at* http://www.natlaw.com/seminar/doc34.pdf, at 5. Professor Mark Scarberry has observed that lenders are uniquely vulnerable because of the private mortgage insurance (PMI) exclusion. Statement of Mark S. Scarberry, Before the Senate Committee on the Judiciary Hearing on "The Looming Foreclosure Crisis: How To Help Families Save Their Homes," December 5, 2007. But some private mortgage insurers do not exclude bankruptcy strip down from their master policies. *See, e.g.*, Radian Insurance Corp., Master Policy, *at* http://www.radian.biz/pdf/master_policy.pd, at 16; State of New York's Mortgage Agency's Mortgage Insurance Fund's Master Policy, *at* http://nyhomes.org/docs/mmigenc3pol.pdf, at 28. Thus lack of PMI coverage for strip down from major private mortgage insurers seems to be attributable to lack of lender demand, as indicated in the lender's own pricing.

Even when there is an exclusion for bankruptcy strip down, however, the exclusion applies not just to currently non-modifiable mortgages, but to all types of mortgages, and a lender can never be sure that what is an owner-occupied principal residence at the time a mortgage loan is made will be so in the future (and PMI coverage always excludes fraud). Thus, lenders have been assuming the risk of strip-down all along and not relying on PMI. Prospectively, though, if strip down risk grows, it is reasonable to expect markets to adjust, as lenders will demand modification coverage from PM insurers or find equivalent coverage through swap and derivative products.

PMI rates include additional premiums for investor properties, above what is charged for single-family principal residences.[22] Because PMI covers the same risks that the lender assumes when there is a down payment of 20% or more, we can compare the additional PMI premium on investor properties with the additional interest rate premium charged on investor property mortgages.[23] In other words, by subtracting the additional PMI premium on investor properties relative to single-family owner-occupied properties, from the additional interest rate charged on investor properties relative to single-family owner-occupied properties, we can isolate the amount of the additional interest rate that covers the PMI exclusions of bankruptcy modification, special hazard, and fraud.

The typical interest rate spread between investor properties and single-family primary residences is 38 basis points.[24] There is also a 38 basis point spread in the PMI rates for investor properties and single-family primary residences charged by leading private mortgage insurers such as AIG United Guaranty, Genworth Mortgage Insurance Company, and the Mortgage Guaranty Insurance Corporation.[25]

Because the additional PMI premium, which does not cover bankruptcy modification losses, is the same as the additional interest rate premium, it appears that mortgage lenders, who bear the cost of bankruptcy modification, view bankruptcy modification risk as negligible and do not factor it into their pricing.

(3) Freddie Mac and Fannie Mae Delivery Fee Variation by Property Type

The indifference of the market to bankruptcy modification risk in mortgage pricing is also apparent from the delivery fees charged by Freddie Mac and Fannie Mae, the two largest purchasers of home mortgages on the secondary market. Freddie Mac and Fannie Mae charge a delivery fee, essentially a discount rate, on the mortgages they purchase from originators. The discount rate varies by the characteristics of the mortgage product, such as property type, LTV ratio, and the borrower's credit score.

Notably, Freddie and Fannie have additional discount fees for investor properties and some multi-family residences, but not for vacation homes or for

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[22] PMI also typically includes a premium of 14 basis points for second homes, which is not tracked by mortgage pricing. Because most second home purchasers put down at least 20% of the purchase price, they are not required to have PMI coverage. Therefore, the additional PMI premium for second homes likely reflects the smaller (and riskier) coverage pool of second home buyers who do not put down at least 20% of the purchase price.

[23] Lender PMI coverage requirements are required to terminate when the loan-to-value ratio reaches 78%. 12 U.S.C. §§ 4901(18), 4902(b).

[24] Kittle, *supra* note 37, at 3. *See also* Table 3.

[25] AIG United Guaranty, Rates, *at* https://www.ugcorp.com/rates/Monthly.pdf; Genworth Financial, Genworth Mortgage Insurance Company, National Rate Plans, Standard Annual Premium, *at* http://mortgageinsurance.genworth.com/pdfs/Rates/NationalRates.pdf; MGIC National Rate Card, January 2008, *at* http://www.mgic.com/pdfs/71-6704_Natl_rates_jan08.pdf.

certain multi-family residences configurations.[26] The absence of a risk premium on all properties that can currently be modified in bankruptcy indicates that Freddie and Fannie are not pricing for bankruptcy modification risk. This evidence conforms to the pricing in the mortgage origination market. Given that a significant percentage of mortgage originations are sold into a secondary market[27] and that GSEs are the largest players in the secondary market, Freddie and Fannie pricing shapes mortgage origination pricing, so it is not surprising to see parallel pricing indifference. All current observational evidence indicates that the mortgage lending market is indifferent to bankruptcy modification risk.[28]

Explaining Market Indifference to Bankruptcy Strip Down: Evidence from the 2001 Consumer Bankruptcy Project

The market's indifference to bankruptcy modification risk may be explained by the small likelihood and magnitude of the risk relative to all the other factors that determine mortgage interest rates. This is shown by an analysis of the mortgage claims in the 2001 Consumer Bankruptcy Project database. The 2001 CBP database is, an extensive multi-district database collected during the 2001 mini-recession.[29]

2001 CBP data provides us with an estimate of the impact on lenders of allowing bankruptcy strip down on all mortgages. Strip-down is only one type of possible modification, but it is the most drastic because it affects the treatment of the principal of the mortgage claim, as well as the interest. The Bankruptcy Code provides very different protections for secured and unsecured claims in Chapter 13. Secured claims are entitled to receive at least the value of their claims under a plan, unless the debtor surrenders the property or the lender consents to alternative treatment.[30] Unsecured Chapter 13 claims are entitled only to receive only as much as they would have received in a chapter 7 liquidation, which is frequently nothing.[31]

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[26] Freddie Mac, *Post-Delivery Fees, Exhibit 19* (Dec. 21, 2007), *at* http://www.freddiemac.com/singlefamily/pdf/ex19.pdf; Fannie Mae, *Loan Level Price Adjustment (LLPA) Matrix* (Dec. 7, 2007), *at* https://www.efanniemae.com/sf/refmaterials/llpa/pdf/llpamatrix.pdf.

[27] It is estimated that 75 percent of outstanding first-lien residential mortgages are held by securitization trusts, and that two-thirds are in GSE MBS. Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More*, Mar. 12, 2007, at 28. Freddie and Fannie MBS comprise over 44% of residential first-lien mortgage debt outstanding. *Id.*

[28] Likewise, there has been no problem securitizing mortgage debts that are modifiable, such as family farm mortgages, vacation home, multiunit, and investor properties. Indeed, the largest securitization market is in bankruptcy-modifiable, non-mortgage debts, such as credit cards and car loans. *See* Federal Reserve Statistical Release G.19.

[29] The 2001 CBP has data from the Central District of California, the Eastern District of Pennsylvania, the Middle District of Tennessee, the Northern District of Illinois, and the Northern District of Texas.

[30] 11 U.S.C. § 1325(a)(5).

[31] 11 U.S.C. § 1325(a)(4).

Strip down bifurcates a mortgage lender's bankruptcy claim into a secured claim for the value of the collateral and an unsecured claim for the deficiency. Because the unsecured claim is frequently of negligible value, strip down has a much more dramatic effect on a mortgage lender than other types of modification, such as extending the term of the loan, changing its amortization schedule, or changing its interest rates. Indeed, the requirement that plan pay at least the present value of a secured claim lender severely limits non-strip down modifications, and the Supreme Court has set a floor for modified interest rates of secured creditors in Chapter 13 of the prime rate, subject to various adjustments.[32] This means that by examining historical data on potential strip downs we are examining the worst-case scenario for lenders.

Only a small percentage of mortgages ever end up in bankruptcy. There is no data on the exact percentage, but if we use foreclosure rates as a guideline, it seems safe to estimate that less than 1% of all first-lien mortgages end up in bankruptcy. Since at least 1993, foreclosure rates have hovered around 1% of all outstanding mortgages.[33] Many mortgage delinquent homeowners never file for bankruptcy, however, although some do file before foreclosure proceedings commence. Of the mortgages that end up in bankruptcy, many will not end up in Chapter 13. Extrapolating from the 2001 CBP database, we can estimate that of the mortgages that end up in bankruptcy, 75% will end up in Chapter 13. We are cautious about this particular extrapolation from the 2001 CBP database, however, because the database was drawn from five federal judicial districts, and there is tremendous variation by district in the percentage of non-business bankruptcy filings that are Chapter 13.[34]

Within the limited universe of mortgages that end up in Chapter 13, the 2001 CBP is more instructive. The 2001 CBP database has information on 1095 mortgage claims in Chapter 13 cases. Of these claims, under 18% were undersecured, around 4% were fully secured, and approximately 78% were

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[32] Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004). There is reason to believe that the prime rate would not be the relevant interest rate benchmark for mortgages. *Till* dealt with a subprime auto loan with a 21% contract rates of interest. As the prime rate has frequently been above the rate of 30-year fixed mortgages, using the prime rate as a floor could result in an inequitable windfall for creditors. *See* Federal Reserve Statistical Release H.15. Arguably for a mortgage loan, the appropriate base line would be either the average 30-year fixed rate mortgage rate or the 10-year Treasury bond rate. H.R. 3609 would resolve this problem by amending section 1325(a)(5)(B)(ii) to permit "interest accruing after the date of the order for relief under this chapter at an annual percentage rate calculated at a fixed annual percentage rate, in an amount equal to the then most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as of the applicable time set forth in the rules of the Board, plus a reasonable premium for risk."

[33] Mortgage Bankers Association, *National Delinquency Survey*.

[34] *See, e.g.*, Teresa Sullivan *et al.*, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J. L. & PUB. POL'Y 801-865 (1994); Gordon Bermant *et al.*, *Thoughts on the "Local Legal Culture"*, 21 FED. AM. BANKR. INST. J. 24 (2004); Chrystin Ondersma, "Testing the Power of Local Legal Culture: The Bankruptcy Experiment," working paper, Dec. 22, 2007 (on file with authors).

oversecured. The undersecured claims were undersecured by an average of $9,143.93, but the median undersecured Chapter 13 claim was undersecured by only $$6,216.50. On average, undersecured claims were undersecured by only 10% of the total claim amount. In contrast, the average oversecured claim was oversecured by an equity cushion of $46,965.61, or by an average of 71% of the claim amount. The median oversecured claim was oversecured by $57,000.00. Looking at all Chapter 13 mortgage claims, the average claim was oversecured by $35,051.76, which was 50% of the average claim amount.

Table 4. Mortgage Claim Amount to Property Value by Bankruptcy Chapter

	Chapter 7	Chapter 13	Total
Undersecured	10.86%	17.72%	16.02%
Fully Secured	3.06%	4.20%	3.92%
Oversecured	86.07%	78.08%	80.06%

Source: 2001 Consumer Bankruptcy Project Database

Table 5. Mortgages in Chapter 13 (2001 CBP)

	Undersecured	Oversecured	Fully Secured	All
Number	194	855	46	1095
Market Value				
Average	$79,542.55	$113,204.91	$64,568.15	$105,197.80
Std. Error	$3,439.08	$2,558.61	$4,178.84	$2,146.12
Median	$71,500.00	$95,000.00	$59,500.00	$90,000.00
Claim Amount				
Average	$88,686.48	$66,239.30	$64,568.15	$70,146.04
Std. Error	$3,597.32	$1,935.58	$4,178.84	$1,669.13
Median	$77,792.00	$57,000.00	$59,500.00	$61,471.00
Market Value Minus Claim Amount				
Average	-$9,143.93	$46,965.61	$0.00	$35,051.76
Std. Error	$675.51	$1,976.76	$0.00	$1,691.40
Median	-$6,216.50	$26,000.00	$0.00	$14,750.00
Average Difference Between Market Value and Claim Amount as a Percentage of Claim Amount	-10.31%	70.90%	0.00%	49.97%

Source: 2001 Consumer Bankruptcy Project Database

Table 6. Mortgages in Chapter 7 (2001 CBP)

	Undersecured	Oversecured	Fully Secured	All
Number	39	309	11	359
Market Value				
Average	$77,487.23	$120,892.80	$76,681.82	$114,822.78
Std. Error	$8,131.90	$4,328.75	$13,130.51	$3,927.07
Median	$75,000.00	$74,000.00	$98,500.00	$94,000.00
Claim Amount				
Average	$94,392.23	$71,025.62	$76,681.82	$73,737.36
Std. Error	$9,538.97	$3,151.32	$13,130.51	$2,949.33
Median	$82,000.00	$74,000.00	$63,000.00	$65,183.00
Market Value Minus Claim Amount				
Average	-$16,905.00	$49,867.18	$0.00	$41,085.42
Std. Error	$3,278.71	$3,273.85	$0.00	$3,067.77
Median	-$9,884.00	$0.00	$30,844.00	$24,000.00
Average Difference Between Market Value and Claim Amount as a Percentage of Claim Amount	-17.91%	70.21%	0.00%	55.72%

Source: 2001 Consumer Bankruptcy Project Database

Table 7. Mortgages in Chapters 7 and 13 Combined (2001 CBP)

	Undersecured	Oversecured	Fully Secured	All
Number	233	1164	57	1454
Market Value				
Average	$79,198.53	$115,245.77	$66,905.88	$107,574.26
Std. Error	$3,163.49	$2,204.15	$4,204.05	$1,887.24
Median	$72,000.00	$95,000.00	$60,000.00	$90,000.00
Claim Amount				
Average	$89,641.52	$67,509.90	$66,905.88	$71,032.76
Std. Error	$3,387.86	$1,650.08	$4,204.05	$1,452.77
Median	$80,000.00	$58,220.50	$60,000.00	$62,356.00
Market Value Minus Claim Amount				
Average	-$10,443.00	$47,735.87	$0.00	$36,541.50
Std. Error	$804.34	$1,691.92	$0.00	$1,483.02
Median	-$6,500.00	$26,479.50	$0.00	$16,582.50
Average Difference Between Market Value and Claim Amount as a Percentage of Claim Amount	-11.65%	70.71%	0.00%	51.44%

Source: 2001 Consumer Bankruptcy Project Database

If section 1322(b)(2) were amended to allow modification of all mortgages, only undersecured mortgage claims in Chapter 13 cases, a very small subset of all mortgages, could be stripped down. Therefore, even if we make the overly conservative assumption that there will no recoveries on the undersecured portion of the claim, lenders' losses on undersecured mortgages if strip-down were allowed would be limited to 10% of their claim. These are losses a lender would almost assuredly incur in a foreclosure situation and are far less than the 40%-50% of loan value lenders are estimated to typically lose in foreclosure.

In other words, even without the Bankruptcy Code's anti-modification provision,[35] mortgage lenders have not historically been exposed to substantial losses, even in the most radical scenario of strip down. This explains, then, why mortgage markets have shown no sensitivity to bankruptcy modification risk. Strip down is a risk of very small probability and magnitude. Strip down losses, relative

[35] 11 U.S.C. § 1322(b)(2).

to the size of the mortgage market, are just too inconsequential for lenders and are not specifically figured into pricing models.[36]

Evaluating the Mortgage Bankers Association's Modification Impact Claim

The Mortgage Bankers Association (MBA) has claimed that permitting modification of mortgages in bankruptcy will result in an effective 200 basis point increase in interest rates on single-family owner-occupied properties ("principal residences").[37] The MBA figure is derived from a comparison of the current interest rate spread between mortgages on single-family principal residences and on investor properties.[38] It includes not only the current additional interest rate premium for investor properties of 37.5 basis points, but also amortizes the higher down payments and points generally required on investor properties in order to achieve the 200 basis point figure.[39] More recent MBA press releases have claimed only an increase of 150 basis points, without explaining the 50 basis point decline from the 200 basis point figure featured in Congressional testimony.[40] The MBA figure is based on an assumption that the entire spread between principal residence and investor property mortgage interest rates is due to lack of modification protection on investor properties.

Our research on current mortgage interest rate spreads among different property types disproves the MBA's claim. The MBA's calculation is based on

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[36] Although the 2001 CBP data was collected during a recession, relative to the current market, it likely presents lower figures for both the percentage of undersecured loans and the amount by which they are undersecured. But we would still need to assume that the amount by which claims are undersecured relative to total claim amount has increased more than four to five times in order for lender losses in strip down to outweigh lender losses of 40-50% of investment value in foreclosure. Many of the undersecured loans today will be the 80-10-10s and 80-15-5s, structured so as to allow buyers to purchase homes with low down payments and not purchase private mortgage insurance to protect the lenders from losses. It is unclear why lenders who forewent insurance protection against defaults should gain greater protection in bankruptcy. Going forward, the 2001 CBP data is likely a reasonable predictor of lender losses after the resolution of the current mortgage crisis.

It is, of course, possible that there will also be a larger percentage of mortgages ending up in Chapter 13, but early empirical evidence on the impact of the 2005 BAPCPA indicates that it has had only a *de minimis* effect of channeling debtors into Chapter 13. *See* Executive Office of the United States Trustee, *Report to Congress: Impact of the Utilization of Internal Revenue Service Standards for Determining Expenses on Debtors and the Court*, July 2007. In any event Chapter 13 filing rates varied tremendously by district historically and have continued to do so post-BAPCPA. *See supra* note

[37] Statement of David G. Kittle, CMB, Chairman-Elect, Mortgage Bankers Association, Before the Subcommittee on Commercial and Administrative Law, Committee on Judiciary, United Stated House of Representatives, Oct. 30, 2007, Hearing on "Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress? – Part II," at http://judiciary.house.gov/media/pdfs/Kittle071030.pdf, at 3.

[38] *Id.*

[39] *Id.*

[40] Mortgage Bankers Association, Press Release, MBA's "Stop the Cram Down Resource Center" Puts a Price Tag on Bankruptcy Reform, Jan. 15, 2008, *at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/59343.htm.

looking selectively at the effective interest rate spread between investment properties and single-family principal residences. But mortgages on investor properties are not the only type of property that can currently be modified in bankruptcy. Mortgages on vacation homes and on multifamily residences in which the owner occupies one unit can also be modified currently. As noted above, conforming mortgages on vacation homes and multifamily properties are currently priced the same as single-family principal residences. Only investor property mortgages are priced higher. This pattern is confirmed by PMI rates and Fannie/Freddie delivery fees. This means higher interest rates on investor properties must be attributed to non-bankruptcy risk factors entailed in lending against an investor property.[41]

The MBA figure is thus the result of a cherry-picked comparison.[42] Likewise, if our historical experiment provides a reasonable basis for extrapolating to the current market, and we believe it provides general parameters, then there is a zero percent chance that the MBA's statistic is correct. All empirical and market observational data indicates that that MBA's claim of an effective 150-200 basis point increase from allowing strip-down is groundless. The empirical evidence indicates that there is unlikely to be anything more than a *de minimis* effect on interest rates as a result of permitting bankruptcy modification.

A Caveat About the Policy Implications of Our Study

Empirical work is frequently misinterpreted in policy debates, and we wish to express a pair of important caveats about the interpretation of our findings. First, our study affirmatively does not find that there will be any specific increase in mortgage interest rates if strip-down is permitted, as legislation pending in the House and Senate propose. The historical section of our study finds that strip-down results in a range of possible outcomes on interest rates with point estimates in the range of a 5-15 basis point increase, although the possibility that strip-down has no effect on interest rates cannot be rejected in some of our specifications. The overwhelming thrust of the historical analysis, however, is that the effect of permitting strip-down on mortgage interest rates, although most likely positive,

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[41] *See supra* at 16 for a discussion of factors impacting investor property mortgage rates.

[42] Additionally, the MBA's amortization of the higher down payments typically required on investor properties is debatable. Lenders bear no risk on down payments, unlike on interest payments. Down payments receive different tax treatment than interest payments for borrowers. And down payments create equity in a house, unlike interest. By amortizing down payments—turning them into interest dollar for dollar adjusted for present value— the MBA is equating two very different types of payments that should not be treated as dollar for dollar equivalents.

Regardless, even if the MBA were correct is correct that higher down payments and/or points will be required and that it will be harder to make high LTV loans, this is not necessarily a bad thing, as it might compel more prudent lending practices and would inherently protect lenders from ending up with undersecured loans that could be stripped down by creating an instant equity cushion.

would be small—nothing near the range suggested by the Mortgage Bankers Association.

Our historical findings must also be reconciled with our section on current mortgage rate pricing, which suggests that markets are indifferent to bankruptcy modification risk. There may well have been changes in the mortgage lending market, such as improved credit-scoring, that would make it easier for lenders to screen out or price for riskier borrowers than they could in the late 1980s and early 1990s. If so, then the current market observational data might well be a better predictive guide. Based on the two sections of our study, our overall conclusion is limited to stating that permitting strip-down would likely have no or little effect overall on mortgage interest rates.

Second, to the extent our findings are used as a guide for predicting the impact of pending legislation, it is important to note that pending legislation is likely to have a more limited impact on prospective mortgage interest rates than the ranges our study predicts because the pending legislation would permit strip-down only of existing mortgages. Likewise, the pending legislation includes a variety of limitations on modification, including means testing, that would diminish the likely impact on mortgage interest rates relative to our findings by further limiting the possible universe of mortgages that can be modified.

Conclusion

Based on our initial study, there is no empirical evidence that supports a conclusion that permitting either strip-down or other forms of modification of principal home mortgage loans in bankruptcy would have more than a minor impact on mortgage interest rates or on home ownership rates. As there is significant evidence that mortgage interest rate markets are indifferent to bankruptcy modification risk, we conclude that permitting strip-down would have no or little effect overall on mortgage interest rates.